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# **DIGITAL MONEY: BITCOIN'S FINANCIAL AND TAX FUTURE DESPITE REGULATORY UNCERTAINTY**

## **INTRODUCTION**

Bitcoin, an electronic currency created in 2009, has resulted in the unlikely pairing of underworld criminals with the Harvard-educated Winklevoss brothers.<sup>1</sup>

Bitcoin is an online currency obtained by “mining” through solving a set of complex mathematical equations.<sup>2</sup> It can be bought and sold with foreign currency (including USD) through Bitcoin Exchanges.<sup>3</sup> Bitcoin resembles gold in that both are forms of “private currency” supplied by the private sector and not subject to central bank control or government involvement.<sup>4</sup> Proponents of private currency argue that inflation levels are more stable because the currency is not subject to government regulation or possible corruption.<sup>5</sup> Due to its highly anonymous and untraceable nature, Bitcoin is notorious for criminal use on the Silk Road, an illegal marketplace where users can purchase everything from drugs and forged documents to hit men.<sup>6</sup> In addition to its use by criminals, Bitcoin has been used in many legitimate ways. For instance, wholesale websites such as Overstock.com and other private parties accept Bitcoin as payment for goods and services,<sup>7</sup> and Bitcoin has been used as an investment vehicle similar to

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1. See generally Winklevoss Bitcoin Trust, Registration Statement (Form S-1), at 26–38 (July 1, 2013), available at <http://www.sec.gov/Archives/edgar/data/1579346/000119312513279830/d562329ds1.htm>.

2. *Id.* at 28–29. Bitcoin Exchanges are online trading realms where users can exchange Bitcoins for currency, including the U.S. dollar. *Id.* at 26.

3. See *supra* note 2.

4. *Gold Could Collapse Just Like Bitcoin Did*, BUS. INSIDER (Apr. 28, 2013, 10:14 AM), <http://www.businessinsider.com/three-reasons-gold-is-like-bitcoin-2013-4>; see also Nicholas A. Plassaras, Comment, *Regulating Digital Currencies: Bringing Bitcoin Within the Reach of the IMF*, 14 CHI. J. INT'L L. 377, 384 (2013); Alen Mattich, *Bitcoin vs. Gold: A Tale of Two Manias*, WALL ST. J. MONEYBEAT (Nov. 22, 2013, 8:28 AM), <http://blogs.wsj.com/moneybeat/2013/11/22/bitcoin-vs-gold-a-tale-of-two-manias/>.

5. Plassaras, *supra* note 4, at 382.

6. Sealed Complaint at 4–5, 6, 9–11, *United States v. Ulbricht*, No. 13 MAG 2328 (S.D.N.Y. Sept. 27, 2013) [hereinafter Ulbricht Complaint].

7. Amit Chowdhry, *Overstock.com Is Going To Accept Bitcoin in 2014*, FORBES (Dec. 21, 2013, 2:13 PM), <http://www.forbes.com/sites/amitchowdhry/2013/12/21/overstock-com-is-going-to-accept-bitcoin-in-2014/> (a Forbes Contributor blog).

foreign currency.<sup>8</sup> Despite its widespread use, government agencies have been slow to regulate the various aspects and uses of Bitcoin.

As the first agency to extend its regulations to Bitcoin, the Financial Crimes Enforcement Network (FinCEN) has determined that Bitcoin is a virtual currency, and thus Bitcoin Exchanges must comply with anti-money laundering laws and the regulations applicable to money service businesses.<sup>9</sup> Additionally, the Internal Revenue Service (IRS) has issued Notice 2014-21, which treats Bitcoin as property under the Internal Revenue Code (Code).<sup>10</sup> Most recently, the Commodity Futures Trading Commission (CFTC) approved the TeraExchange, making it the “only U.S. regulated trading platform for Bitcoin swap contracts.”<sup>11</sup> All other federal regulatory bodies have declined to investigate the issue until Bitcoin is viewed as a legitimate future currency and not a “house of cards.”<sup>12</sup>

This Comment argues that Bitcoin should be classified as “currency” under all regulatory laws in the same fashion as other foreign currencies. Bitcoin should not be regulated as property or as a commodity. Further, Bitcoin Exchanges should comply with FinCEN guidelines and the Bank Secrecy Act (BSA), which should also extend to Bitcoin miners because they are in the business of transferring funds. To provide investor protection, the Securities and Exchange Commission (SEC) should regulate investments in certain Bitcoin financial products. By classifying Bitcoin as property and not as currency, the IRS has taken an inaccurate view of Bitcoin, resulting in unnecessary administrative and regulatory confusion. Additionally,

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8. See *infra* notes 217–238 and accompanying text.

9. FIN. CRIME ENFORCEMENT NETWORK, DEP'T OF THE TREASURY, FIN-2013-G001, APPLICATION OF FINCEN'S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES 3 (2013) [hereinafter FIN-2013-G001], available at [http://www.fincen.gov/statutes\\_regs/guidance/pdf/FIN-2013-G001.pdf](http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf).

10. I.R.S. Notice 2014-21, IRB 2014-16 (Apr. 14, 2014), available at [www.irs.gov/pub/irs-irbs/irb14-16.pdf](http://www.irs.gov/pub/irs-irbs/irb14-16.pdf).

11. *TeraExchange Solutions*, TERAEXCHANGE, <http://www.teraexchange.com/bitcoin.html> (last visited Oct. 11, 2014); see also Michael J. Casey, *TeraExchange Unveils First U.S.-Regulated Bitcoin Swaps Exchange*, WALL ST. J. (Sept. 12, 2014, 2:06 PM), <http://online.wsj.com/articles/teraexchange-launches-bitcoin-derivatives-exchange-1410543989> (“A [B]itcoin derivatives exchange announced that its trading platform had received approval from the Commodity Futures Trading Commission . . .”).

12. Robin Sidel, *Bitcoin Group, Regulators To Meet*, WALL ST. J. (Aug. 25, 2013, 8:14 PM), <http://online.wsj.com/news/articles/SB10001424127887324906304579035192895707228>; see also Ryan Tracy, *Authorities See Worth of Bitcoin*, WALL ST. J. (Nov. 18, 2013, 11:56 PM), [http://online.wsj.com/news/article\\_email/SB10001424052702304439804579205740125297358-MyQjAxMTAzMDExODExNDgyWj;CFTC's Chilton: Want To Ensure Bitcoin Is Not a “House of Cards,”](http://online.wsj.com/news/article_email/SB10001424052702304439804579205740125297358-MyQjAxMTAzMDExODExNDgyWj;CFTC's%20Chilton%3A%20Want%20to%20Ensure%20Bitcoin%20Is%20Not%20a%20House%20of%20Cards) WALL ST. J. MARKETWATCH (May 7, 2013, 8:04 AM), <http://blogs.marketwatch.com/thetell/2013/05/07/cftcs-chilton-want-to-ensure-bitcoin-is-not-a-house-of-cards/>.

the Commodity Future Trading Commission (CFTC) should continue regulating certain Bitcoin derivatives to establish price stability.

Part II of this Comment provides a fundamental definition of Bitcoin and how it operates, including its use as a payment mechanism.<sup>13</sup> Part II also describes the issues stemming from Bitcoin's anonymity, price volatility, and use in criminal activity.<sup>14</sup> Part II further explores the recent regulatory and other legal developments surrounding Bitcoin.<sup>15</sup> Part III provides an analysis of classifying and regulating Bitcoin as currency and examines how FinCEN and Treasury Regulations issued by the IRS will reduce criminal activity stemming from anonymity.<sup>16</sup> Additionally, Part III discusses how SEC and CFTC regulations could stabilize Bitcoin's volatile market value.<sup>17</sup> Part III also explains why it was incorrect for the IRS to classify Bitcoin as property.<sup>18</sup> Part IV addresses the policy implications of classifying Bitcoin as currency under various regulatory laws.<sup>19</sup>

## II. BACKGROUND

### A. *What Is Bitcoin and How Does It Operate?*

In 2009, Satoshi Nakamoto created a "peer-to-peer electric cash system" that allows users to transact business without intermediary third parties, including governments.<sup>20</sup> Influenced by the Austrian economic theory of "private currency," Bitcoin is not subject to inflation caused by monetary supply changes because it is independent from a central bank.<sup>21</sup>

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13. See *infra* notes 20–99 and accompanying text.

14. See *infra* notes 20–99 and accompanying text.

15. See *infra* notes 99–151 and accompanying text.

16. See *infra* notes 152–255 and accompanying text.

17. See *infra* notes 152–255 and accompanying text.

18. See *infra* notes 201–248 and accompanying text.

19. See *infra* notes 258–281 and accompanying text.

20. For a more detailed explanation, see Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, <http://bitcoin.org/bitcoin.pdf> (last visited Aug. 30, 2014). *Business Insider* recently named Satoshi Nakamoto its "Most Impressive Person of 2013." Rob Wile, *Why Bitcoin Inventor "Satoshi Nakamoto" Is the Most Impressive Person of 2013*, *BUS. INSIDER* (Dec. 17, 2013, 1:18 PM), <http://www.businessinsider.com/satoshi-nakamoto-person-of-the-year-2013-12>.

21. Plassaras, *supra* note 4, at 379; see also EUROPEAN CENT. BANK, *VIRTUAL CURRENCY SCHEMES*, OCTOBER 2012, at 22, 35 (2012), available at <http://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf> (noting that Bitcoin's theoretical roots stem from the theory of Austrian Economics); Geoffrey E. Wood, *Introduction to F.A. HAYAK, DENATIONALISATION OF MONEY* 19 (3d ed. 2007), available at <http://www.iea.org.uk/sites/default/files/publications/files/upldbook431pdf.pdf> (discussing inflation and competition in currency markets); Donna Borak, *Yellen: Fed Doesn't Have Authority To Regulate Bitcoin*, *AM. BANKER* (Feb. 27, 2014, 1:42 PM), [http://www.americanbanker.com/issues/179\\_40/yellen-fed-doesnt-have-authority-to-regulate-bitcoin-1065934-1.html](http://www.americanbanker.com/issues/179_40/yellen-fed-doesnt-have-authority-to-regulate-bitcoin-1065934-1.html) ("Federal Reserve Board Chair Janet Yellen said

In order to transact with Bitcoins, users must download a “wallet” (analogous to an online account) on a computer or mobile device to store Bitcoins.<sup>22</sup> This wallet contains both a private key component and a public key component.<sup>23</sup> To initiate a transaction, the wallet-holder provides her public key to the other party.<sup>24</sup> The wallet-holder uses her private key to access her account and will lose access to all Bitcoins within her wallet if she loses this key.<sup>25</sup>

Bitcoins are generated through “mining” via a computer software program that miners use to add data “blocks” to a pre-existing chain of blocks (Blockchain) by solving complex mathematical equations.<sup>26</sup> Even though mining is a complex computer process, “[a]nybody can become a Bitcoin miner by running software with specialized hardware.”<sup>27</sup> The complexity of these problems ensures the Bitcoin Network’s fixed production of 1 block per 10 minutes or 6 blocks per hour to prevent an influx of mining.<sup>28</sup> The Blockchain acts as a ledger of all Bitcoin transactions to prevent double spending, fraudulent generation of Bitcoin, and the reversal of prior transactions.<sup>29</sup> Additionally, the Blockchain becomes a digital file that can be easily transferred to others on the Bitcoin network or converted into USD on Bitcoin Exchange markets.<sup>30</sup> Bitcoin Exchange markets are websites where people can trade Bitcoins for foreign currency based on the going exchange rate.<sup>31</sup> The most popular Bitcoin Exchanges are Bitstamp, Bitfinex, BTC-e, and BTC China.<sup>32</sup>

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Thursday that the central bank does not have the power to supervise Bitcoin, the most widely recognized digital currency.”).

22. Winklevoss Bitcoin Trust, *supra* note 1, at 26.

23. *Id.* at 27.

24. *Id.* at 27.

25. *Id.*

26. *Id.* at 28. For a more detailed explanation of the mathematical calculations and technology behind the mining process, see Nakamoto, *supra* note 20, at 6–7.

27. *Frequently Asked Questions*, BITCOIN.ORG, <https://bitcoin.org/en/faq#mining> (last visited Aug. 30, 2014).

28. Sarah Gruber, Note, *Trust, Identity, and Disclosure: Are Bitcoin Exchanges the Next Virtual Havens for Money Laundering and Tax Evasion?*, 32 QUINNIPIAC L. REV. 135, 148–49 (2013).

29. Winklevoss Bitcoin Trust, *supra* note 1, at 27.

30. *Id.* at 26.

31. *Id.* In addition to exchanges, Bitcoin owners in Vancouver, Canada can cash their Bitcoins via ATM. See Robert McMillan, *Take a Tour of Robocoin, the World’s First Bitcoin ATM*, WIRED (Oct. 29, 2013, 12:09 PM), [http://www.wired.com/wiredenterprise/2013/10/bitcoin\\_atm\\_gallery](http://www.wired.com/wiredenterprise/2013/10/bitcoin_atm_gallery) (an example of the world’s first Bitcoin ATM).

32. The majority of Bitcoin trading happens on these exchanges, and they compete for the top spot as the most popular Bitcoin Exchange. *Exchange Volume Distribution*, BITCOIN CHARTS, <http://bitcoincharts.com/charts/volumepie/> (last visited Mar. 2, 2014). There are numerous other Bitcoin Exchanges, including BitBox, EXANTE Bitcoin Fund, and Localbitcoins.com. See generally *Overview*, BITCOIN CHARTS, <http://bitcoincharts.com/markets/> (last visited Mar. 2, 2014).

In order to prevent inflation, the mining process has a mathematically controlled function that halts mining at certain specified levels.<sup>33</sup> Modeled after the mining rate for gold, the amount of Bitcoins awarded for block creation will reduce by 50% every four years.<sup>34</sup> The first “halving day” occurred on November 28, 2012, when miners were awarded 25 Bitcoins for every block created, compared with the 50 Bitcoins per block created previously awarded.<sup>35</sup> Currently, over 11 million Bitcoins have been mined, and it is estimated that more than ninety percent of the 21 million fixed supply of Bitcoin will be mined by 2020.<sup>36</sup>

### B. Bitcoin as an Alternative Form of Payment

Bitcoin was created to transact business independent of third party financial intermediaries.<sup>37</sup> Without involvement from a central bank or financial institution, Bitcoin transactions result in lower costs than traditional methods of payment such as credit cards.<sup>38</sup> As opposed to Bitcoin, credit cards require processing time and charge users fees. Additionally, transfer and receipt with Bitcoin occurs almost simultaneously, making it the more convenient option.<sup>39</sup> Paying for goods and services with Bitcoin has become a quicker and more cost effec-

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33. *Id.* at 30; *see also* Nakamoto, *supra* note 20, at 6–8.

34. Gruber, *supra* note 28, at 149 (citing *Controlled Supply*, BITCOIN WIKI, [https://en.bitcoin.it/wiki/Controlled\\_Currency\\_Supply](https://en.bitcoin.it/wiki/Controlled_Currency_Supply) (last modified July 8, 2014)). Because Bitcoin mining is fixed to create a desired supply and thus reduce issues regarding inflation that burden government printed currency, supporters have compared Bitcoin to gold. *See, e.g.*, Maureen Farrell, *Winklevoss Twins: Bitcoins Better Than Gold*, CNN MONEY (Sept. 17, 2013, 12:38 PM), <http://money.cnn.com/2013/09/17/investing/bitcoin-winklevoss-twins/>. Like gold, Bitcoin retains its value despite central banking monetary policy because the price is independent of that policy. *Id.*

35. *Id.* (citing *Bitcoin Community Celebrates “Halving Day,”* PRL0G (Nov. 28, 2012), <http://www.prlog.org/12032578-bitcoin-community-celebrates-halving-day.html>).

36. Winklevoss Bitcoin Trust, *supra* note 1, at 30.

37. Nakamoto, *supra* note 21, at 1.

38. Susan A. Berson, *Virtual Money: Some Basic Rules for Using “Bitcoin”*, A.B.A. J., Jul. 2013, at 32.

39. *Id.*

tive alternative to other payment forms.<sup>40</sup> Bitcoin payment is quick and irreversible, ensuring payment on the spot for services rendered.<sup>41</sup>

Recognizing Bitcoin's low transaction costs, companies like Circle Internet Financial Inc. (Circle) are developing new ways to attract merchants.<sup>42</sup> Venture capital firms have invested millions of dollars in Circle, which "aims to develop services that make it easier for businesses and consumers to use digital currencies."<sup>43</sup> Raj Date, a former official with the Consumer Financial Protection Bureau, has "jump[ed] on the [B]itcoin bandwagon" by joining Circle.<sup>44</sup> Moreover, prior to China's ban on financial institutions engaging in Bitcoin transactions, Chinese Internet retailer Baidu accepted payment in Bitcoins.<sup>45</sup> Despite this ban, Bitcoin will likely become a more acceptable payment method in the U.S. as more venture capitalists and institutional investors adopt the currency.<sup>46</sup> For example, the private equity firm Fortress Investment Group purchased \$20 million in Bitcoin in 2013.<sup>47</sup>

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40. *Id.* Accordingly, the general counsel for the Bitcoin Foundation accepted Bitcoins from clients because it was a faster option than sending a bill and waiting for a check, and cheaper than credit card payments because of transaction fees. *Id.* Other merchants that accept Bitcoin as payment include "WordPress.com, a blogging service, and dating website OkCupid." Joe Light, *For Virtual Prospectors, Life in the Bitcoin Mines Gets Real: Temperatures, Electric Bills Rise as Enthusiasts Hunt for Web Currency*, WALL ST. J. (SEPT. 19, 2013, 10:39 PM), [http://online.wsj.com/news/article\\_email/SB10001424127887324665604579079721277783300-MyQjAxMTAzMDEwNDEwNDQyWj](http://online.wsj.com/news/article_email/SB10001424127887324665604579079721277783300-MyQjAxMTAzMDEwNDEwNDQyWj). One couple has even traveled three continents (Asia, Europe, and North America) using only Bitcoin. Paul Vigna, *Bitcoin Couple Travels the World Using Virtual Cash: World-Wide Odyssey Spanned Three Continents and Proved One Can Live on Bitcoin Alone*, WALL ST. J. (Nov. 14, 2013, 12:43 AM), <http://online.wsj.com/news/articles/SB10001424052702303559504579196301325588672-lMyQjAxMTAzMDEwNDEwNDQyWj>. The couple's goal was to live and travel paying solely with Bitcoin. *Id.* They persuaded others to join the Bitcoin craze, like their landlord, who set up a Bitcoin account to receive the couple's rent, and a pizza joint owner. *Id.* Even a gas station in Utah accepted Bitcoin. *Id.*

41. See Berson, *supra* note 38.

42. See Robin Sidel, *Hire of Raj Date Boosts Bitcoin Credibility*, WALL ST. J. (Nov. 14, 2013, 12:13 AM), [http://online.wsj.com/news/article\\_email/SB10001424052702303559504579196301325588672-lMyQjAxMTAzMDEwNDEwNDQyWj](http://online.wsj.com/news/article_email/SB10001424052702303559504579196301325588672-lMyQjAxMTAzMDEwNDEwNDQyWj).

43. *Id.*

44. *Id.*

45. *Baidu Stops Accepting Bitcoins After China Ban*, BLOOMBERG (Dec. 7, 2013, 1:59 AM), <http://www.bloomberg.com/news/2013-12-07/baidu-stops-accepting-bitcoins-after-china-ban.html>. The Chinese government banned financial institutions from engaging in Bitcoin transactions, but private individuals are still able to trade freely in Bitcoins. *Id.*

46. *Id.*

47. Paul Vigna, *Fortress Investment Group Bought \$20 Million of Bitcoin in 2013*, WALL ST. J. MONEYBEAT (Feb. 28, 2014, 10:35 AM), [http://blogs.wsj.com/moneybeat/2014/02/28/fortress-investment-group-bought-20-million-of-bitcoin-in-2013/?mod=wsj\\_valettop\\_email](http://blogs.wsj.com/moneybeat/2014/02/28/fortress-investment-group-bought-20-million-of-bitcoin-in-2013/?mod=wsj_valettop_email). Gil Luria, managing director of equity research at Wedbush Securities, noted that "[f]or all intents and purposes, this is the first public company to report ownership of [B]itcoin." *Id.*

### C. Anonymity and Related Criminal Activity

The anonymous nature of Bitcoin has both disadvantages and advantages. This Comment argues that the disadvantages of criminal activity and susceptibility to hackers outweigh the advantage of privacy. Although infrequent, hackers have taken advantage of flaws within Bitcoin's software code. In 2010, a group of hackers fraudulently obtained 184 billion Bitcoins by exploiting a flaw in the code, constituting a security breach.<sup>48</sup> This error was reversed within a few hours and the code was modified to prevent similar flaws in the future.<sup>49</sup>

The most concerning security breach for Bitcoin investors occurred in 2014 when an estimated 850,000 Bitcoins<sup>50</sup> went missing from Toyko-based Mt. Gox, a trading platform that once accounted for 80% of Bitcoin transactions.<sup>51</sup> This theft amounted to 6% of the Bitcoins then in circulation, "valued at about \$400 million at current prices."<sup>52</sup> Mt. Gox "has said that a flaw in the [B]itcoin software allowed transaction records to be altered, potentially making possible fraudulent withdrawals."<sup>53</sup> Customers could not withdraw funds during this time.<sup>54</sup> Mt. Gox was initially unable to recover its customers' money or Bitcoins and filed for bankruptcy in Japan days after the theft.<sup>55</sup> Hours after filing, a U.S. customer filed a class action lawsuit asserting numerous allegations, including fraud, in order "to recoup millions of dollars of losses linked to a hacking attack."<sup>56</sup>

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48. Winklevoss Bitcoin Trust, *supra* note 1, at 32.

49. *Id.*

50. Jacqueline Palank, *Mt. Gox Could Follow Japan Bankruptcy with U.S. Case*, WALL ST. J. BANKRUPTCY BEAT (Feb. 28, 2014, 11:50 AM), <http://blogs.wsj.com/bankruptcy/2014/02/28/mt-gox-could-follow-japan-bankruptcy-with-u-s-case/>. Of the 850,000 missing Bitcoins, 750,000 were stolen from customers' accounts, and 100,000 were from Mt. Gox's own account. *Id.*

51. Robin Sidel et al., *Shutdown of Mt. Gox Rattles Bitcoin Market*, WALL ST. J. (Feb. 26, 2014, 1:21 PM), <http://online.wsj.com/news/articles/SB10001424052702304834704579404101502619422>.

52. *Id.*

53. Greg Shill, *Could Your Holdings Survive the Failure of the NYSE?*, CONGLOMERATE (Feb. 25, 2014), <http://www.theconglomerate.org/2014/02/could-your-holdings-survive-the-failure-of-the-nyse.html>.

54. *Id.*

55. Palank, *supra* note 50 (noting that a similar bankruptcy proceeding in the U.S. is likely). There are rumors that Mt. Gox is undergoing a rebranding effort that includes hiring a new CEO and reducing its outstanding liabilities. Sophie Knight & Takaya Yamaguchi, *Japan Says Any Bitcoin Regulation Should Be International*, REUTERS (Feb. 27, 2014, 6:50 PM), <http://www.reuters.com/article/2014/02/27/us-bitcoin-mtgox-idUSBREA1Q1YK20140227>.

56. Jonathan Stempel & Emily Flitter, *Mt. Gox Sued in United States over Bitcoin Losses*, REUTERS (Feb. 28, 2014, 12:50 PM), <http://www.reuters.com/article/2014/02/28/bitcoin-mtgox-lawsuit-idUSL1N0LX1QK20140228>. See generally Complaint, *Greene v. MtGox Inc.*, No. 1:14-cv-01437 (N.D. Ill. filed Feb. 27, 2014).



Bitcoin's anonymity makes it difficult to track transactions, and therefore difficult to reverse and recover fraudulent transactions.<sup>57</sup> Despite this difficulty, "two bitslueths at letstalkbitcoin.com" are attempting to trace the money trail from the recent Mt. Gox theft.<sup>58</sup> To recover the lost money, the bitslueths need to identify which transactions correspond to which account holders, but Mt. Gox has not released the account information necessary for recovery.<sup>59</sup> Mt. Gox was able to recoup 200,000 of the 850,000 missing Bitcoins, but CEO Mark Karpales "doesn't believe more will be found[,] leaving many creditors waiting for Mt. Gox's liquidation and bankruptcy."<sup>60</sup>

In addition to hackers and theft, for the past two and a half years Bitcoin has been synonymous with criminal use on an underground website known as the Silk Road.<sup>61</sup> This website was run through The Onion Router (TOR) network, which is a series of virtual tunnels on the "deep-net" that provide privacy and anonymity to users by concealing the true IP address of each computer within its network.<sup>62</sup> The anonymity of the TOR network, coupled with the fact that transactions were paid exclusively in Bitcoins, meant that Silk Road transactions were almost entirely untraceable.<sup>63</sup> In September 2013, however, the FBI brought an action against the alleged creator and operator of the Silk Road, Ross William Ulbricht, and shut down the website.<sup>64</sup> The federal government seized 3.6 million Bitcoins, worth approximately 1.6B USD.<sup>65</sup> The FBI estimated that the website gen-

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57. See Borak, *supra* note 21 (stating that Senator Joe Manchin, "an outspoken critic of the digital currency," commented that "[a]nonymity combined with Bitcoin's ability to finalize transactions quickly, makes it very difficult, if not impossible, to reverse fraudulent transactions").

58. Neelabh Chaturvedi, *Bitslueths Start Hunt for Mt. Gox's Missing Bitcoins*, WALL ST. J. MONEYBEAT (Feb. 28, 2014, 12:41 PM), <http://blogs.wsj.com/moneybeat/2014/02/28/bitslueths-start-hunt-for-mt-goxs-missing-bitcoin/> (noting that "[i]t's possible to go back in time and (pains-takingly) trace the virtual addresses through which each [B]itcoin moved").

59. See *id.*

60. Takashi Mochizuki & Eleanor Warnock, *Mt. Gox Head Believes No More Bitcoins Will Be Found*, WALL ST. J. (June 29, 2014, 11:23 AM), <http://online.wsj.com/articles/mt-gox-head-believes-no-more-bitcoin-will-be-found-1403850830>.

61. Danny Yadron, *Feds Nab Alleged Leader of "Silk Road" Online Drug Market*, WALL ST. J. DIGITS (Oct. 2, 2013, 1:55 PM), <http://blogs.wsj.com/digits/2013/10/02/feds-nab-alleged-leader-of-silk-road-online-drug-market/>; see also Ulbricht Complaint, *supra* note 6, at 5, 9–12.

62. Derek A. Dion, Note, *I'll Gladly Trade You Two Bits on Tuesday for a Byte Today: Bitcoin, Regulating Fraud in the e-Conomy of Hacker-Cash*, 2013 U. ILL. J.L. TECH. & POL'Y 165, 166–67 (2013); see also *TOR: Overview*, TOR, <https://www.torproject.org/about/overview>; Adrian Chen, *Underground Website Lets You Buy Any Drug Imaginable*, WIRED (June 1, 2011, 2:25 PM), <http://www.wired.com/2011/06/silkroad-2/>; Ulbricht Complaint, *supra* note 6, at 5, 7–8.

63. Ulbricht Complaint, *supra* note 6, at 6.

64. *Id.*

65. See Tracy Alloway & Kara Scannell, *Bitcoin Prices Continue To Fall Following Silk Road Raid in U.S.*, FIN. TIMES (Oct. 3, 2013, 10:58 AM), <http://www.ft.com/intl/cms/s/0/27ca2d60-2b89-11e3-a1b7-00144feab7de.html#axzz2hulNDrDJ>.

erated total revenues of 9.5 million Bitcoins (1.2B USD), and over 600,000 Bitcoins (80M USD) in commissions.<sup>66</sup> Following this raid, the market value per Bitcoin fell from \$141 to a low of \$109.70.<sup>67</sup> Furthermore, this seizure resulted in the U.S. government holding 22% of the Bitcoin market, equaling 3.6 million Bitcoins worth approximately 1.6B USD.<sup>68</sup> Observers speculated about whether the government could use these Bitcoins and what result government use would have on the value of Bitcoin.<sup>69</sup> These questions are similar to those that arise in cases of cash seizure from more traditional criminal busts.<sup>70</sup> In June of 2014, the government auctioned approximately 30,000 of the Bitcoins seized from the Silk Road bust.<sup>71</sup> Venture capitalist Tim Draper won the auction and plans use the proceeds to expand Bitcoin use in developing economies.<sup>72</sup>

Bitcoin users did not waste time finding a replacement website operator who announced the revival of the Silk Road publically via his Twitter account.<sup>73</sup> The Silk Road will continue selling the same illegal drugs and merchandise, but with enhanced security measures and “insurance against users losing their Bitcoins.”<sup>74</sup>

Bitcoin-based investments have also been subject to white-collar crime through Ponzi schemes.<sup>75</sup> In 2013, the SEC charged Trendon Shavers with operating a Ponzi scheme through his investment vehicle Bitcoin Savings and Trust (BTCST).<sup>76</sup> Since 2011, Shavers offered a weekly 7% interest rate from this trust, where he obtained more than 700,000 Bitcoins (amounting to more than 4.5M USD) from investors.<sup>77</sup> In response to this case and numerous other occurrences of

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66. *Id.*; see also Ulbricht Complaint, *supra* note 6, at 6.

67. Alloway & Scannell, *supra* note 66.

68. *Id.*

69. See, e.g., Robert McMillian & Cade Metz, *The Ultimate Bitcoin Question: Can the Feds Spend the \$3.3M in Seized Digital Currency?*, WIRED (Oct. 8, 2013, 6:30 AM), <http://www.wired.com/2013/10/silk-road-bust/>.

70. *Id.*

71. Sydney Ember, *Winner of Bitcoin Auction Plans To Expand Currency's Use*, N.Y. TIMES, July 3, 2014, at B6. This auction accounted for only 20% of the Bitcoins seized and may provide a map for the U.S. Marshals to auction off the remaining 80% in the future. *Id.*

72. *Id.*

73. Devin Coldewey, *Silk Road 2.0 Rises from the Ashes—with Improvements*, NBC NEWS TECH. (Nov. 6, 2013, 3:24 PM), <http://www.nbcnews.com/tech/internet/silk-road-2-0-rises-ashes-improvements-f8C11545412>.

74. *Id.*

75. See, e.g., SEC v. Shavers, No. 4:13-CV-416, 2013 WL 4028182, at \*1 (E.D. Tex. filed Aug. 6, 2013) (memorandum opinion regarding the court's subject matter jurisdiction).

76. *Id.* at \*1–2.

77. *Id.*; see also Robin Sidel & Saabira Chaudhuri, *Bitcoin Price Hits a New Record*, WALL ST. J. (Nov. 13, 2013, 3:14 PM), <http://online.wsj.com/news/articles/SB1000142405270230378960v4579195773841529160>.

questionable Bitcoin investment offerings, the SEC issued an alert cautioning investors about the risks inherent in these investment vehicles.<sup>78</sup>

Moreover, tax evasion has resulted from the anonymous nature of Bitcoin use.<sup>79</sup> Prior to the March 2014 issuance of Notice 2014-21, the IRS had not released clear guidelines on how virtual currency transactions were to be taxed.<sup>80</sup> However, even after the IRS issued Notice 2014-12 stating that Bitcoin will be treated as property for tax purposes, there is little ability to compel payment because Bitcoin is difficult to trace.<sup>81</sup> Because Bitcoin transactions take place between two willing parties and never pass through a financial intermediary, the IRS has no simple way of tracing the transactions in order to tax them.<sup>82</sup> Given its untraceable and therefore difficult to tax nature, opponents have labeled Bitcoin as a “digital Cayman Islands.”<sup>83</sup>

#### D. Price Volatility

The value of Bitcoin is not regulated by a central bank like the Federal Reserve.<sup>84</sup> Instead, market supply and demand determine the price of the currency, resulting in price fluctuations.<sup>85</sup> Because the

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78. Ponzi Schemes Using Virtual Currencies, SEC Investor Alert, Pub. No. 153 (7/13) (2013), available at [http://www.sec.gov/investor/alerts/ia\\_virtualcurrencies.pdf](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf).

79. David D. Stewart & Stephanie Soong Johnston, *Digital Currency: A New Worry for Tax Administrators?*, TAX ANALYSTS (Nov. 7, 2012), [www.taxanalysts.com/www/features.nsf/Articles/C1A7ED502DD2B84685257AAF0056A2A2](http://www.taxanalysts.com/www/features.nsf/Articles/C1A7ED502DD2B84685257AAF0056A2A2).

80. See I.R.S. Notice 2014-21, *supra* note 10.

81. *Id.* See generally Omri Marian, *Are Cryptocurrencies Super Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38 (2013), available at <http://www.michiganlawreview.org/first-impressions/volume/112> (discussing Bitcoin as a new avenue for tax evasion and concluding that “[c]ryptocurrencies offer, at least theoretically, a near-perfect alternative to tax-evaders who can no longer find a safe haven in tax-haven jurisdictions”). Further challenges to Bitcoin taxation include uncertainty over income characterization and basis calculations. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-13-516, VIRTUAL ECONOMIES & CURRENCIES: ADDITIONAL IRS GUIDANCE COULD REDUCE TAX COMPLIANCE RISKS 15–16 (2013) [hereinafter GAO-13-516].

82. *FBI Raid Heralds Campaign Against Tax Evasion*, SOC’Y TR. & EST. PRAC. (Oct. 7, 2013), <http://www.step.org/fbi-raid-heralds-campaign-against-bitcoin-tax-evasion>; see also Marian, *supra* note 81, at 42.

83. Kelsey Snell, *Who Needs a Cayman Account When You’ve Got Bitcoin?*, POLITICO MORNING TAX (Aug. 9, 2013, 9:27 AM), <http://www.politico.com/morningtax/0813/morningtax11385.html>. See generally Marian, *supra* note 81.

84. See *supra* note 4.

85. J.P. | London & G.T. | Melbourne, *Bits and Bob*, ECONOMIST (June 13, 2011, 8:30 PM), <http://www.economist.com/blogs/babbage/2011/06/virtual-currency>. Additionally, “Bitcoin is a payment innovation that’s taking place outside the banking industry. . . . So the Federal Reserve has no authority to supervise or regulate [it] . . .” Dominic Rushe, *Janet Yellen: Federal Reserve Has No Authority To Regulate Bitcoin*, GUARDIAN (Feb. 27, 2014, 1:11 PM), <http://www.theguardian.com/business/2014/feb/27/janet-yellen-federal-reserve-no-authority-regulate-bitcoin>. But see Chris Matthews, *Is the Fed Quietly Planning New Bitcoin Regulations?*, FORTUNE (May 20, 2014, 10:33 AM), <http://fortune.com/2014/05/20/is-the-fed-quietly-planning-new-bitcoin-regulations/>.

rate of Bitcoin supply is fixed, an increase in demand without a corresponding increase in supply creates drastic price increases, similar to those seen in the California Gold Rush of 1849.<sup>86</sup> For instance, concern over the “safety of traditional banking and paper currency” and the banking crisis in Cyprus caused Bitcoin prices to soar to an all time high.<sup>87</sup>

Bitcoin’s price fluctuations are partly due to the small number of Bitcoins used in the retail and commercial marketplaces as compared with the larger use by speculative investors.<sup>88</sup> This price volatility and corresponding speculation appeal to risk-prone investors, like venture capitalists.<sup>89</sup> Yet, for the risk-averse investor, Bitcoin’s price volatility is detrimental because an investor stands to lose large amounts through investment in Bitcoin.<sup>90</sup>

Bitcoin’s price will likely remain volatile as long as the government continues prosecuting illegal activity, as evidenced by the drop in price to \$90 per Bitcoin in October, 2013 following the raid on the Silk Road.<sup>91</sup> These government crackdowns on illegal Bitcoin activity will likely legitimize the currency in the long run, but will also subject it to short-term price fluctuations.<sup>92</sup> For example, in November 2013, the price of Bitcoin reached an all-time high, trading at \$1,242 per Bitcoin.<sup>93</sup> This record high was attributed to confidence related to perceptions of Bitcoin becoming a viable alternative payment method.<sup>94</sup> This confidence will continue to increase as venture capitalists and institutional investors pour money into Bitcoin startups.<sup>95</sup>

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86. Chris Isidore, *Bitcoin Price Goes on Wild Ride*, CNN MONEY (Apr. 3, 2013, 2:11 PM), <http://money.cnn.com/2013/04/03/investing/bitcoin-price/>.

87. Matt Egan, *As Cyprus Implodes, Bitcoin Interests Explode*, FOXBUSINESS (Mar. 22, 2013), <http://www.foxbusiness.com/investing/2013/03/22/bitcoin-interest-explodes-as-cyprus-nearly-implodes/>.

88. Winklevoss Bitcoin Trust, *supra* note 1, at 9.

89. Wangfeng Zhou & Nick Olivair, *Bitcoin Buzz Grows Among Venture Investors, Despite Risks*, REUTERS (Oct. 1, 2013, 7:47 PM), <http://www.reuters.com/article/2013/10/01/us-markets-forex-bitcoin-idUSBRE9901HA20131001>. Investors who choose to hold Bitcoin as an investment speculate about the future price, gaining a large profit if the price increases. *Id.*; see also Radoslav Albrecht, *Bitcoin Volatility—The 4 Perspectives*, BITCOIN MAG. (Aug. 27, 2013), <http://bitcoinmagazine.com/6543/bitcoin-volatility-analysis/>.

90. Albrecht, *supra* note 89; see also *Charts*, BITCOIN CHARTS, <http://bitcoincharts.com/charts/> (last visited Mar. 2, 2014) (charting the volume traded against the exchange rate for Bitcoin).

91. *Charts*, *supra* note 90 (select the “Custom Time” box and enter “2013-10-1” to “2013-10-3” for the date range).

92. *Id.*

93. Neils Christensen, *2013: Year of the Bitcoin*, FORBES (Dec. 10, 2013, 2:34 PM), <http://www.forbes.com/sites/kitconews/2013/12/10/2013-year-of-the-bitcoin/> (a Forbes Contributor blog).

94. See *id.*

95. See *id.*; see also Jesse Columbo, *Bitcoin May Be Following This Classic Bubble Stages Chart*, FORBES (Dec. 19, 2013, 12:09 PM), <http://www.forbes.com/sites/jessecolombo/2013/12/19/>

As further indicia of this increasing confidence, the theft of nearly 850,000 Bitcoins from Mt. Gox in February, 2014 and subsequent bankruptcy proceeding dropped the price per Bitcoin below \$500, but the price recovered at \$538 per Bitcoin later that day.<sup>96</sup> In the aftermath of the Mt. Gox theft, Bitcoin began consistently trading at \$550, which “suggests that many people still see value in its potential to improve online payment systems.”<sup>97</sup> The collapse of one of the largest Exchanges could have been the end of Bitcoin, yet it quickly recovered at a stable trading price.<sup>98</sup> This occurrence suggests that Bitcoin “emerged stronger” from the theft at Mt. Gox.<sup>99</sup>

### *E. Regulatory Developments as of October 10, 2014*

#### *1. Financial Crime Enforcement Network*

FinCEN, a bureau within the U.S. Department of Treasury, is responsible for regulating financial institutions and providing safeguards from money laundering.<sup>100</sup> FinCEN operates under the BSA.<sup>101</sup> FinCEN issued guidance stating that virtual currency-based exchanges must follow the same laws and regulations as money service businesses and other financial institutions.<sup>102</sup> The extension of these regu-

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bitcoin-may-be-following-this-classic-bubble-stages-chart/ (a Forbes Contributor blog). Some investors are wary of Bitcoin's continued increase in price, attributing the increase to a speculative price bubble, similar to the silver bubble beginning in 2010. These investors note that Bitcoin's true value is less than the current market price. Columbo, *supra*.

96. Sidel et al., *supra* note 51.

97. James Freeman, Opinion, *Can Anything Kill Bitcoin?*, WALL ST. J. (Feb. 28, 2014, 7:47 AM), [http://online.wsj.com/news/article\\_email/SB10001424052702303801304579410721981026040](http://online.wsj.com/news/article_email/SB10001424052702303801304579410721981026040).

98. *Charts*, *supra* note 90 (select the “Custom Time” box and enter “2013-10-1” to “2013-10-3” for the date range).

99. Craig Timberg, *Mt. Gox Collapse Spurs Calls To Regulate Bitcoin*, WASH. POST (Feb. 28, 2014), [http://www.washingtonpost.com/business/technology/mt-gox-collapse-spurs-calls-to-regulate-bitcoin/2014/02/28/df44f5c6-a0b7-11e3-a050-dc3322a94fa7\\_story.html](http://www.washingtonpost.com/business/technology/mt-gox-collapse-spurs-calls-to-regulate-bitcoin/2014/02/28/df44f5c6-a0b7-11e3-a050-dc3322a94fa7_story.html) (“If you look at the short history of Bitcoin, there's been a series of bubbles and busts, there's been a series of disruptions, there have been hacks, there have been thefts. And really, after every single event, Bitcoin has emerged stronger.”); *see also* Freeman, *supra* note 90.

100. *What We Do*, FINCEN, [http://www.fincen.gov/about\\_fincen/wwd/](http://www.fincen.gov/about_fincen/wwd/) (last visited Aug. 23, 2014).

101. 31 U.S.C. §§ 5311–5330 (2012).

102. Jeffrey Sparshott, *Regulator on Bitcoin: Same Rules Apply*, WALL ST. J. (Aug. 26, 2013, 5:13 PM), <http://online.wsj.com/news/articles/SB10001424127887323407104579037301852662422>.

31 C.F.R. § 1010.100(ff) (2013) defines a money service business as

[a] person wherever located doing business whether or not on a regular basis or as an organized or licensed business concern, wholly or in substantial part within the United States, in one or more of the capacities listed in paragraphs (ff)(1) through (ff)(7) of this section. This includes but is not limited to maintenance of any agent, agency, branch, or office within the United States.

lations, however, applies only to Bitcoin Exchanges, not “users” of the currency.<sup>103</sup>

On January 26, 2014, federal authorities arrested Bitcoin activist Charles Shrem, alleging “money laundering, operating an unlicensed money-transmitting business[,] and failure to file a suspicious-activity report” in connection with a Bitcoin currency exchange he owns.<sup>104</sup> As the first governmental agency to extend its regulations to Bitcoin, this action demonstrates that FinCEN considers its current laws and regulations under the BSA applicable to Bitcoin.<sup>105</sup> Some argue that FinCEN is trying “to squeeze a square technological peg into its round regulatory hole.”<sup>106</sup> Others see this as a first step toward other regulatory agencies classifying Bitcoin, Bitcoin Exchanges, and trading markets.<sup>107</sup> Regardless, FinCEN has jumpstarted the regulatory process.

## 2. Securities and Exchange Commission

In response to the stock market crash of 1929 and the Great Depression, Congress created the SEC to regulate financial products and markets through disclosure requirements.<sup>108</sup> Prior to the Securities Act of 1933 (Securities Act), investors knew little about securities and “fell prey to fraudsters manipulating the markets, as well as companies who operated with unique accounting schemes and often would not disclose negative facts.”<sup>109</sup>

Pursuant to the Securities Act, the SEC regulates only “securities,” a classification that includes notes, stock, treasury stock, and investment contracts.<sup>110</sup> In *SEC v. W. J. Howey Co.*, the Supreme Court

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Note that FinCEN is not stepping on any other agency’s toes by excluding any “person registered with, and functionally regulated or examined by, the SEC or the CFTC.” 31 C.F.R. § 1010.100 (ff)(8)(ii) (2014).

103. FIN-2013-G001, *supra* note 9; *see also* Timothy B. Lee, *New Money Laundering Guidelines Are a Positive Sign for Bitcoin*, FORBES (Mar. 19, 2013, 4:42 PM), <http://www.forbes.com/sites/timothylee/2013/03/19/new-money-laundering-guidelines-are-a-positive-sign-for-bitcoin/> (a Forbes Contributor blog).

104. Robin Sidel, *Hard Times for a Bitcoin Evangelist*, WALL ST. J. (Feb. 5, 2014, 8:52 PM), [http://online.wsj.com/news/article\\_email/SB10001424052702304450904579365201803918312](http://online.wsj.com/news/article_email/SB10001424052702304450904579365201803918312).

105. *See* J.P. | London & G.T. | Melbourne, *supra* note 85.

106. *See* Lee, *supra* note 103.

107. *See* J.P. | London & G.T. | Melbourne, *supra* note 85.

108. *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SECURITIES & EXCHANGE COMMISSION, <http://www.sec.gov/about/whatwedo.shtml> (last visited Aug. 31, 2014). The Securities Act of 1933 provides registration and disclosure requirements for financial products, whereas the Securities and Exchange Act of 1934 regulates the secondary financial markets once products are registered. *Id.*

109. Dion, *supra* note 62, at 192–93.

110. 15 U.S.C. § 77b (2012); *see also* Dion, *supra* note 62. For a complete list of “securities,” *see* 15 U.S.C. § 77b(a)(1).

defined an investment contract as “a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”<sup>111</sup> In *SEC v. Shavers*, a Texas district court held that an investment in a Bitcoin financial product was an investment contract, giving the SEC jurisdiction over certain Bitcoin investments.<sup>112</sup> The defendant Trendon Shavers fraudulently invested more than \$4.5 million in a Bitcoin trust operating as a Ponzi scheme.<sup>113</sup> The court reasoned that because Bitcoin can be used for goods and services and can be converted into U.S. dollars or other foreign currencies, it is money.<sup>114</sup> The court also found that an investment in the Bitcoin trust was a common enterprise because the investors relied on the defendant’s expertise in the Bitcoin markets to derive a profit.<sup>115</sup> Consequently, the district court held that the investments in Shaver’s Bitcoin trust met the definition of “security,” giving the SEC jurisdiction to prosecute Shavers for violating antifraud provision of the securities laws.<sup>116</sup>

In July 2013, the Winklevoss brothers (famous for their lawsuit<sup>117</sup> against Facebook CEO, Mark Zuckerberg<sup>118</sup>) filed with the SEC for an Initial Public Offering (IPO) of the Winklevoss Bitcoin Trust (Trust).<sup>119</sup> This Trust would create an exchange-traded fund (ETF) to

111. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

112. *SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182, at \*2 (E.D. Tex. filed Aug. 6, 2013) (memorandum opinion regarding the court’s subject matter jurisdiction) (holding that investments in the entity “Bitcoin Savings and Trust,” which offered investors Bitcoin based investment products, were investment contracts under the *Howey* test).

113. *Id.* at \*1.

114. *Id.* at \*2.

115. *Id.* “[I]nterdependence between the investors and the promot[er] . . . ‘ may be demonstrated by the investors’ collective reliance on the promoter’s expertise even where the promoter receives only a flat fee or commission rather than a share in the profits of the venture.’” *Id.* (quoting *Long v. Shultz Cattle Co.*, 881 F.2d 129, 141 (5th Cir. 1989)).

116. *Id.* at \*2. On September 18, 2014, the Court granted the SEC’s motion for summary judgment, finding that “[t]he uncontested summary judgment evidence established that Shavers knowingly and intentionally operated BTCST as a sham and a Ponzi Scheme.” *SEC v. Shavers*, No. 4:13-CV-416, 2014 U.S. Dist. LEXIS 130781, at \*22–23 (E.D. Tex. Sept. 18, 2014). The Court ordered a permanent injunction against further violations of Section 10(b) of the Securities Exchange Act of 1934 and Section 17(a) and 5 of the Securities Act of 1933. *Id.* at \*35–38. The Court further held that “Shavers and BTCST are jointly and severally liable for disgorgement . . . of \$40,404,667.” *Id.* at \*38.

117. *See ConnectU LLC v. Zuckerberg*, 522 F.3d 82 (1st Cir. 2008); *see also Facebook, Inc. v. Pac. Nw. Software, Inc.*, 640 F.3d 1034 (9th Cir. 2011).

118. *See Facebook, Inc.*, Registration Statement (Form S-1), at 95 (Feb. 1, 2012), *available at* <http://www.sec.gov/Archives/edgar/data/1326801/000119312512034517/d287954ds1.htm>.

119. Winklevoss Bitcoin Trust, *supra* note 1; *see also* Chuck Jaffe, *Don’t Laugh Off the Winklevoss Bitcoin ETF*, MARKETWATCH, (July 8, 2013, 11:31 AM), <http://www.marketwatch.com/story/dont-laugh-off-the-winkleviis-bitcoin-etf-2013-07-08> (comparing the Bitcoin-based ETF to a gold-based ETF).

purchase Bitcoins and offer shares of ownership, providing investors with exposure to Bitcoin through an intermediary party.<sup>120</sup> The price of the ETF is based on the “Blended Bitcoin Price,” which uses the daily trading values for Bitcoin to determine profits.<sup>121</sup> The benefits of investing in this Trust, rather than in Bitcoins directly, include (1) security (such that Bitcoins cannot be lost if the code is lost, like with storage in a wallet); (2) the ease of investing in the Trust as opposed to purchasing Bitcoins directly; and (3) lower transaction costs as a result of the ease in investing in the Trust.<sup>122</sup> For tax purposes, the Trust treats Bitcoin as a capital asset.<sup>123</sup> The prevalence of Bitcoin financial products like the Trust will likely increase as Bitcoin becomes more widely accepted.

### 3. Internal Revenue Service

Since its inception, the IRS has been responsible for federal income tax collection and enforcement of the Code.<sup>124</sup> Under the Code, individuals are taxed on gross income less any deductions.<sup>125</sup> Gross income is “income from whatever source derived” including compensation for services, gains from business or property, interest, and dividends.<sup>126</sup> To determine whether something is classified as income, the IRS has a long-standing policy of invoking the “substance over form” doctrine.<sup>127</sup> Under this doctrine, transactions are taxed based on their economic substance rather than their legal form.<sup>128</sup> The policy behind this doctrine is to discourage legal solutions as a means to evade taxpayer liability.<sup>129</sup> This provides insight into why the IRS’s current tax treatment of Bitcoin as property is incorrect.

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120. Winklevoss Bitcoin Trust, *supra* note 1, at 38. The ETF will be listed on the Nasdaq Exchange under the ticker symbol COIN. David Zeiler, *Winklevoss Bitcoin Ticker To Be Nasdaq: COIN*, MONEY MORNING (July 7, 2014), <http://moneymorning.com/2014/07/07/winklevoss-bitcoin-etf-ticker-to-be-nasdaq-coin/>.

121. Winklevoss Bitcoin Trust, *supra* note 1, at 32.

122. *See id.* at 38–39.

123. *Id.* at 68.

124. *See generally Internal Revenue Service (1862–1962) 100th Anniversary*, 40 TAXES 551 (1962).

125. I.R.C. § 63 (2009).

126. 26 C.F.R. § 1.61-1 (2013). I.R.C. § 61(a) lists the most common sources of gross income. For additional, less common sources of gross income, see generally 26 C.F.R. 1.61-14. For the Supreme Court’s interpretation of what constitutes taxable income, see *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), noting that gross income can include “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”

127. *See generally Gregory v. Helvering*, 293 U.S. 465 (1935).

128. *Id.* at 470 (holding that, though a change in the taxpayer’s legal form reduced her taxes, the taxpayer must pay based on the economic substance of the change).

129. *Id.* at 468–69.



The Government Accountability Office has stated that Bitcoin can be treated as “open-flow” virtual currency because, although Bitcoin exists solely online, they can be used to purchase goods and services in the real world and exchanged for foreign currency on Bitcoin Exchanges.<sup>130</sup> Despite this classification, the IRS issued Notice 2014-21 in March 2014, stating that Bitcoin is treated as property under the Code.<sup>131</sup> Pursuant to this notice, taxpayers are subject to either ordinary income or capital gains tax treatment for various Bitcoin transactions.<sup>132</sup> Examples of taxable transactions include exchanging Bitcoin for other property and Bitcoin mining.<sup>133</sup> One way the IRS increases taxpayer compliance is through information reporting. An example of this can be seen in Form 1099-B, which is required to report transactions with a third party that exceed a certain amount.<sup>134</sup> After IRS Notice 2014-21, Bitcoin users must comply with the information reporting requirements applicable to other forms of property.<sup>135</sup>

#### 4. *Commodity Futures Trading Commission*

Congress created the Commodity Futures Trading Commission (CFTC) and enacted the Commodity Exchange Act (CEA) to regulate markets that are comprised of financial instruments, the value of which is derived from an underlying asset.<sup>136</sup> Under the CEA, the CFTC is responsible for regulating derivatives, including futures contracts, which are defined as “agreements to buy or sell a specified quantity of a commodity at a particular price for delivery at a set future date.”<sup>137</sup> Through the Dodd-Frank Wall Street Reform and Con-

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130. GAO-13-516, *supra* note 81, at 5. Compare “open flow” virtual currencies to “closed-flow” virtual currencies, in which the currency is used only for purchase of virtual goods, not exchanged for government-issued currencies or real goods and services. *Id.* at 4.

131. I.R.S. Notice 2014-21, *supra* note 10, at 938.

132. *Id.* at 939.

133. *Id.*

134. GAO-13-516, *supra* note 81, at 9. For example, Form 1099-B is required for reporting proceeds from barter exchanges. *See* Dion, *supra* note 62, at 197–98 (arguing that Bitcoin exchanges should be required to comply with IRS regulations and file a Form 1099-B when necessary).

135. I.R.S. Notice 2014-21, *supra* note 10, at 939.

136. *See* Commodity Exchange Act, 7 U.S.C. §§ 1–26 (2012); *see also* *Mission & Responsibilities*, U.S. COMMODITY FUTURES TRADING COMMISSION, <http://www.cftc.gov/About/MissionResponsibilities/index.htm>; BLACK’S LAW DICTIONARY 509 (9th ed. 2009) (explaining that a derivative financial instrument can come from a stock, foreign currency, or a commodity such as corn or wheat).

137. Richard B. Levin et al., *Dread Pirate Roberts, Byzantine Generals, and Federal Regulation of Bitcoin*, J. TAX’N & REG. FIN. INSTITUTIONS, Mar./Apr. 2014, at 5, 18 (2014) (quoting *Dunn v. CFTC*, 519 U.S. 465, 470 (1997)).

sumer Protection Act,<sup>138</sup> the CFTC also regulates derivatives, such as foreign exchange swaps, “defined as ‘an exchange of two different currencies on a specific date at a fixed rate that is agreed on at the inception of the contract covering the exchange; and a reverse exchange of those two currencies at a later date at a fixed rate that is agreed on at the inception of the contract covering the exchange.’”<sup>139</sup>

Although it is unclear whether Bitcoin derivatives could be regulated as commodity futures contracts, former CFTC Commissioner Bart Chilton has stated that “there is more than a colorable argument to be made that derivative products relating to Bitcoin fall squarely in [the CFTC’s] jurisdiction,” and that “[the CFTC] could regulate [Bitcoin] if we wanted.”<sup>140</sup> This suggests that Russian-based ICBIT, a derivatives market where investors can trade in Bitcoin futures contracts, could possibly be regulated by the CFTC as a derivative.<sup>141</sup> The CFTC made a clearer determination of Bitcoin derivatives by approving and regulating the TeraExchange, which created the first Bitcoin Swap Exchange Facility (SEF).<sup>142</sup> Weeks after regulatory approval, TeraExchange announced execution of its first trade.<sup>143</sup> One supporter argues that swaps and other Bitcoin-based derivatives “could help stabilize the future of Bitcoin” by making the price less volatile.<sup>144</sup>

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138. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 U.S.C.). For a discussion of the Dodd-Frank Act and Bitcoin, see David Groshoff, *Kickstarter My Heart: Extraordinary Popular Delusions and the Madness of Crowdfunding Constraints and Bitcoin Bubbles*, 5 WM. & MARY BUS. L. REV. 489, 528 (2014). For the definition of a “swap,” see 7 U.S.C. §1(a)(47); for a discussion of that definition’s relationship to Bitcoin, see Levin, *supra* note 137 at 18.

139. *Id.* (quoting 7 U.S.C. §1(a)(47)).

140. *Id.* (quoting Tracy Alloway et al., *US Regulators Eye Bitcoin Supervision*, FIN. TIMES (May 6, 2013, 7:30 PM), <http://www.ft.com/intl/cms/s/0/b810157c-b651-11e2-93ba-00144feabdc0.html>; and Douwe Miedema, *Regulator Mulls Setting Rules for Digital Currency Bitcoin*, REUTERS (May 6, 2013, 6:32 PM), <http://www.reuters.com/article/2013/05/06/net-us-bitcoin-regulation-idUSBRE9450Y520130506>).

141. Cyrus Farivar, “*Taming the Bubble*”: *Investors Bet on Bitcoin via Derivatives Market*, ARS TECHNICA (Apr. 11, 2013, 7:50 PM), <http://arstechnica.com/business/2013/04/taming-the-bubble-investors-bet-on-bitcoin-via-derivatives-markets/>; see also *ICBIT—The Oldest Bitcoin Derivatives Market*, ICBIT, <https://icbit.se/> (last visited Aug. 26, 2014).

142. Casey, *supra* note 11 (A bitcoin derivatives exchange announced that its trading platform had received approval from the Commodity Futures Trading Commission.”)

143. *TeraExchange Completes First Bitcoin Derivatives Trade on Regulated Exchange*, MARKETWATCH (Oct. 9, 2014, 11:01 AM), <http://www.marketwatch.com/story/teraexchange-completes-first-bitcoin-derivatives-trade-on-regulated-exchange-2014-10-09> (“The initial trade was completed between digitalIBTC, the world’s first [B]itcoin-focused company to commence trading on a major stock exchange, and a hedging counterparty.”).

144. Tim Worstall, *Bringing Derivatives to Bitcoin Should Help Stabilize the Price*, FORBES (Apr. 12, 2013, 12:22 PM), <http://www.forbes.com/sites/timworstall/2013/04/12/bringing-derivatives-to-bitcoin-should-help-stabilise-the-price/> (A Forbes contributor blog).

### 5. *State Regulation*

In addition to federal regulation, several states have issued their own rules and regulations that apply to Bitcoin. Pursuant to A.B. 129, California has lifted the ban on Bitcoin and other virtual currencies as a form of payment.<sup>145</sup> The bill acknowledges Bitcoin's popularity as a virtual currency without giving it the same status as legal tender.<sup>146</sup> Similarly, Texas allows Bitcoin payment transmissions to take place, but does not classify them as "currency transmissions."<sup>147</sup> The New York Department of Financial Services has also proposed legislation requiring a license for Bitcoin businesses that would place a variety of restrictions and requirements on them.<sup>148</sup> Businesses operating under the "BitLicense" would be required to document all transactions and consumer identities in addition to providing "strong cybersecurity to shield their virtual vaults from hackers."<sup>149</sup> Undoubtedly, this BitLicense is intended to provide necessary consumer protection to those transacting in Bitcoins.<sup>150</sup>

## III. ANALYSIS

Bitcoin has many uses. It is primarily utilized for investment in Bitcoin financial products as well as speculating on the value of the currency.<sup>151</sup> It is also used as a method of payment for legal and illegal goods and services.<sup>152</sup> Given its price volatility, Bitcoin has become an increasingly popular investment vehicle.<sup>153</sup> Despite its popularity, Bitcoin is a risky investment, but these risks could be reduced through

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145. CAL. LEGIS. ASSEMB., ASSEMBLY FLOOR ANALYSIS, C.A. A.B.-129 (2014); *see also* Jack Linshi, *California Lifts Ban on Bitcoin*, TIME (June 30, 2014), <http://time.com/2942212/california-bitcoin-legalize/>.

146. Linshi, *supra* note 145.

147. *Id.*

148. Robin Sidel, *N.Y. Proposes Licensing Plan for Bitcoin Businesses*, WALL ST. J (July 17, 2014, 4:20 PM), <http://online.wsj.com/articles/n-y-proposes-licensing-plan-for-bitcoin-businesses-1405611198>.

149. Jacob Davidson, *New York Proposes Bitcoin Regulations*, MONEY (July 18, 2014), <http://time.com/money/3004751/new-york-bitcoin-regulations-benjamin-lawsky/>.

150. *Id.* One supporter of the "BitLicense" argues that "[t]his is a very big important first step, but it's not the ultimate step." *Id.* However, opponents caution that these kinds of regulations will "push major Bitcoin operations outside the United States." *Id.* Regardless, this proposed regulation is the first piece of consumer protection legislation, state or federal, concerning Bitcoin, and this Comment argues it only has limited benefit until uniform regulation becomes widely enacted and accepted.

151. *See* Winklevoss Bitcoin Trust, *supra* note 1, at 35–36.

152. *Id.*

153. Zhou & Olivair, *supra* note 89. Note that risk-prone venture capitalists are investing heavily in Bitcoin startups and financial products like the Bitcoin Investment Trust, in which investors can realize the gains from Bitcoin's volatile price nature without the direct risks associated with Bitcoin ownership. *See id.*

a combination of SEC and CFTC regulations.<sup>154</sup> Extending FinCEN regulations already in place for other virtual currencies to Bitcoin will reduce the criminal activity stemming from its anonymous character. The IRS's treatment of Bitcoin as property is an inaccurate view that fails to acknowledge its evolving use as currency; it is preferable to treat Bitcoin as currency.

### A. Regulatory Agencies

#### 1. Financial Crime Enforcement Network

Although Bitcoin cannot be classified as “real currency” because it is not legal tender, FinCEN has classified Bitcoin as “virtual currency” because it is a “medium of exchange that operates like a currency in some environments,” but it “does not have legal tender status in any jurisdiction.”<sup>155</sup> Unlike Bitcoin, the U.S. dollar is considered legal tender because it is issued and controlled by a central banking authority and can be used to pay legal debts.<sup>156</sup> By extending FinCEN regulations to include virtual currencies, Bitcoin Exchanges and Bitcoin miners must register as money service businesses and abide by money-laundering laws; however, Bitcoin “users,” whether for hobby or investment, are not currently subject to these laws.<sup>157</sup>

Pursuant to guidance issued by FinCEN in 2013, Bitcoin Exchanges are money transmitter businesses because they act as a third-party facilitator of the transmission of funds from buyer to seller.<sup>158</sup> These exchanges are in the business of transferring national currency and Bitcoins for a fee.<sup>159</sup> Under its regulations, FinCEN has stated that Bitcoin miners are not money transmitters when they mine “solely for

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154. Mindi Lowy & Miriam Abraham, *Taxation of Virtual Currency*, 141 TAX NOTES 649, 655 (2013).

155. FIN-2013-G001, *supra* note 9, at 1; *see also* EUROPEAN CENT. BANK, *supra* note 21. Legal tender is a currency recognized by any state or jurisdiction. EUROPEAN CENT. BANK, *supra* note 21, at 16.

156. *See* Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, 4 HASTINGS SCI. & TECH. L.J. 159, 173 (2012); *see also* EUROPEAN CENT. BANK, *supra* note 21, at 9–10.

157. FIN-2013-G001, *supra* note 9, at 2–3; *see also* Lee, *supra* note 103.

158. FIN-2013-G001, *supra* note 9, at 3–4; *see also* FIN. CRIMES ENFORCEMENT NETWORK, DEP'T OF THE TREASURY, FIN-2008-G008, APPLICATION OF THE DEFINITION OF MONEY TRANSMITTER TO BROKERS AND DEALERS IN CURRENCY AND OTHER COMMODITIES 1 (2008) [hereinafter FIN-2008-G008] (quoting 31 C.F.R. § 103.11(uu) (2010)) (noting that FinCEN regulations do not apply to any “person, such as a futures commission merchant, that is ‘registered with, and regulated or examined by . . . the Commodity Futures Trading Commission’”). For a definition of money transmitter that the author believes best suits Bitcoin, *see* 31 C.F.R. § 1010.100 (ff)(5) (2014).

159. *See* 31 C.F.R. § 1010.100(ff)(5). Bitcoin Exchanges can also be classified as a currency dealer or exchanger under 31 C.F.R. § 1010.100(ff)(1). Either classification will suffice for identifying Bitcoin Exchanges as money service businesses under the BSA.

the user's own purposes and not for the benefit of another."<sup>160</sup> However, by analogy, a Bitcoin miner "who creates units and sells those units"<sup>161</sup> should also be classified as a money transmitter because, after creating the currency by solving complex mathematical problems, the miner can accept payment in other currency to place Bitcoins into circulation.<sup>162</sup> Further, individual buyers and sellers of Bitcoins should not be considered money transmitter businesses because they are not involved in the business of transferring funds.<sup>163</sup> An individual user is not transmitting funds during a bona fide sale with another party because the funds transfer is "a fundamental element of the actual transaction necessary to execute the contract for the purchase or sale of the currency or the other commodity," and not a transfer of funds as "a separate and discrete service provided in addition to the underlying transaction."<sup>164</sup>

Exchanges and miners in the business of transferring funds are currently subject to the BSA registration requirements.<sup>165</sup> These requirements include filing reports for suspicious activity, filing requirements for transactions in currency, and implementing an antilaundering program for cash transactions.<sup>166</sup> The BSA requires any money transmitter who transports or receives \$10,000 or more in a single transaction to file a report notifying the U.S. Treasury Department.<sup>167</sup> With Bitcoin's market price averaging \$500 per coin, any Bitcoin Exchange would have to file a report for any transaction including more than

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160. See FIN-2013-G001, *supra* note 9; see also FIN. CRIME ENFORCEMENT NETWORK, DEP'T OF THE TREASURY, FIN-2014-R001, APPLICATION OF FINCEN'S REGULATIONS TO VIRTUAL CURRENCY MINING OPERATIONS (2014) [hereinafter FIN-2014-R001], available at [http://www.fincen.gov/news\\_room/rp/rulings/pdf/FIN-2014-R001.pdf](http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R001.pdf).

161. Bailey Reutzel, *Should Regulations Treat Bitcoin Miners as Money Transmitters?*, PAYMENTS SOURCE (Aug. 16, 2013, 3:42 PM), <http://www.paymentsource.com/news/should-regulations-treat-bitcoin-miners-as-money-transmitters-3015149-1.html>.

162. See *id.* ("A person 'that creates units and sells those units is a money transmitter,' said Judith Rinearson, a partner at Bryan Cave LLP and a recognized authority in payment systems and electronic payments . . ."). For a money transmitter definition applicable to miners, see 31 C.F.R. § 1010.100(ff)(5)(A).

163. See 31 C.F.R. § 103.11(uu)(5)(ii) (2013); see also FIN-2008-G008, *supra* note 158, at 2; Reutzel, *supra* note 161 ("A miner is [a money transmitter] 'if a person is making a business mining bitcoins for sale for real currency,' says Steve Hudak, a spokesman for FinCEN. If they trade it for goods and services they are not, he adds.").

164. FIN-2008-G008, *supra* note 158, at 2.

165. The Bank Secrecy Act is codified at 31 U.S.C. § 53.

166. 31 U.S.C. § 5313(a) (2012); 31 C.F.R. §§ 1010.311, 1022.210, 1022.320 (2014); see also FIN-2008-G008, *supra* note 158, at 1; Sparshott, *supra* note 102 ("[T]rade group[s] and some Bitcoin companies say they support efforts to ensure that the industry is operating in compliance with certain laws. They contend that will help legitimize the fledgling industry and keep out bad players who want to use the currency for illegal activities.").

167. 31 U.S.C. § 5316.

twenty Bitcoins.<sup>168</sup> Presumably, a large portion of Bitcoin transactions involve a sale of more than twenty Bitcoins because investors who trade in large quantities may reap the most benefit, requiring filing.

The BSA reporting requirements could decrease illegal activity and tax evasion by reducing the anonymity of Bitcoin transactions. Critics have argued that the reporting requirements will be ineffective because they require self-reporting, and exchanges will refuse to comply.<sup>169</sup> However, the IRS can apply for a search warrant for any Bitcoin Exchange it believes has been transporting money either without filing a report or by filing an inaccurate report.<sup>170</sup> The government can then seize the property involved in those transactions.<sup>171</sup>

Competition among the large exchanges creates an incentive for self-reporting and compliance with FinCEN regulations.<sup>172</sup> Benjamin Lawsky, New York's superintendent of financial services, "suggested that Bitcoin was moving into an era where law-abiding entrepreneurs were eager to abide by clear regulations on money laundering."<sup>173</sup> Furthermore, the government is paying close attention to Bitcoin Exchanges because of money laundering concerns, which creates an additional incentive to comply with FinCEN requirements.<sup>174</sup> As evidence supporting these claims, Mt. Gox filed its registration with FinCEN on July 1, 2013.<sup>175</sup> Because the market for mining is highly

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168. *Id.* For the current market price of Bitcoin, see the website BITCOIN CHARTS, <http://bitcoincharts.com/charts/> (last visited Sept. 3, 2014). Note the comparison between reporting requirements under the BSA and for the IRS under Form 1099-B, in which brokers and barter exchanges are required to report the sale of "stocks, commodities, regulated futures contracts, foreign currency contracts (pursuant to a forward contract or regulated futures contract), forward contracts, debt instruments, etc., for cash" for all dollar amounts. *Instructions for Form 1099-B—Main Contents*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/instructions/i1099b/ar02.html> (last visited Nov. 5, 2014).

169. See, e.g., Joshua J. Doguet, Comment, *The Nature of the Form: Legal and Regulatory Issues Surrounding the Bitcoin Digital Currency System*, 73 LA. L. REV. 1119, 1149 (2013) (discussing the issues facing the regulation of Bitcoin on an international scale).

170. 31 U.S.C. § 5317(a). The Treasury can apply for a search warrant when it "reasonably believes a monetary instrument is being transported and a report on the instrument under section 5316 of this title has not been filed or contains a material omission or misstatement." *Id.*

171. For criminal and civil forfeiture laws, see 31 U.S.C. § 5317(b)–(c).

172. See Nanette Byrnes, *Behavioral Economics Taps Power of Persuasion for Tax Compliance*, REUTERS (Oct. 29, 2012, 10:17 AM), <http://www.reuters.com/article/2012/10/29/us-usa-tax-behavior-idUSBRE89S0DD20121029>.

173. Stephen Foley, *New York Finance Regulator Voices Backing for Bitcoin*, FIN. TIMES (Jan. 29, 2014, 6:27 PM), <http://www.ft.com/intl/cms/s/0/2b25c-88a9-11e3-9f48-00144feab7de.html>.

174. See Sidel, *supra* note 104. Bitcoin Foundation activist Charles Shrem was recently arrested and charged with violating money-laundering laws in connection with a Bitcoin Exchange he owned and operated. *Id.*

175. Jacob Kastrenakes, *Bitcoin Trader Mt. Gox Registers as Currency Exchange To Comply with U.S. Money Laundering Laws*, VERGE (July 1, 2013, 2:05 PM), <http://www.theverge.com/>

competitive and presents a first-mover advantage, miners “engaged in money transmission”<sup>176</sup> will likely comply with FinCEN regulations. Bitcoin proponents are advocating mainstream compliance with anti-money laundering laws to legitimize Bitcoin’s future as an alternative payment system.<sup>177</sup> Additionally, the IRS would benefit from FinCen reporting requirements by being made aware of large cash transactions that may not have otherwise been reported as income.

## 2. Securities and Exchange Commission

The decision in *SEC v. Shavers* classifies an investment in the Bitcoin Savings and Trust (BTCST) as an “investment contract,” suggesting that Bitcoin investments could be subject to SEC regulation.<sup>178</sup> All investments in Bitcoin financial products, not just the one at issue in *Shavers*, should be considered “securities” as determined by the *Howey* test established in *SEC v. W. J. Howey Co.*<sup>179</sup>

Courts employ the three-part *Howey* test to determine what constitutes an investment contract.<sup>180</sup> The *Howey* test assesses whether an investment product is “a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is lead to expect profits solely derived from the efforts of others.”<sup>181</sup> The three factors of the *Howey* test analyze (1) whether an investor “invests his money;” (2) whether the investment vehicle is a “common enterprise;” and (3) whether the investor “is lead to expect profits solely derived from the efforts of others.”<sup>182</sup> Under the first factor of the *Howey* test, Bitcoin is money because it can be used to purchase

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2013/7/1/4483266/mt-gox-fincen-registration-us-regulation-following-account-seizure (noting that requiring registration with FinCEN legitimizes Bitcoin Exchanges by reducing the threat of illegal activity resulting from anonymity).

176. FIN-2014-R001, *supra* note 160.

177. Foley, *supra* note 173.

178. *SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182, at \*2 (E.D. Tex. filed Aug. 6, 2013) (memorandum opinion regarding the court’s subject matter jurisdiction); *see also* Sarah N. Lynch, *U.S. Judge Says SEC Can Pursue Bitcoin-Related Lawsuit*, REUTERS (Aug. 6, 2013, 6:55 PM), <http://www.reuters.com/article/2013/08/06/us-court-sec-bitcoin-idUSBRE97517G20130806> (stating that classifying Bitcoin as money not only means that the SEC can continue with its case against Shavers, but also that the SEC will be able to closely scrutinize and regulate Bitcoin investments given its tendency for Ponzi schemes and similar abuses).

179. *Cf. Shavers*, 2013 WL 4028182, at \*2; *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946). Investing in the Winklevoss Bitcoin Trust is one avenue for investing in a Bitcoin financial product that provides investors with exposure to Bitcoin without investing directly via mining or through exchanges. *See* Winklevoss Bitcoin Trust, *supra* note 1, at 4. Note that this ETF was filed on July 1, 2013, shortly after the SEC initiated its lawsuit against Trendon Shavers, which could adversely affect approval of the Winklevoss Bitcoin Trust. Lynch, *supra* note 178.

180. *Howey*, 328 U.S. at 299.

181. *Id.*

182. *Id.*

goods and services and can be exchanged for other nations' currencies at a determined exchange rate.<sup>183</sup> Opponents of regulation have argued that Bitcoin is not money because it has no inherent value and thus is ineffective as a medium of exchange for transactions.<sup>184</sup> However, the twenty-first century "welcome[s] a freer and looser regime of money where users and vendors exchange whichever currency most conveniences them."<sup>185</sup> Bitcoin falls within this broader definition of money that includes e-money because market factors assign a value to Bitcoin that can then be used as a medium of exchange for the payment of goods and services or exchanged for other currencies.<sup>186</sup> Investments in Bitcoin financial products like the BTCST are common enterprises under the second factor of the *Howey* test because investors rely on a promoter (the person soliciting the investment) to earn a profit.<sup>187</sup> Investors presume the promoter has knowledge and expertise on how to manage the fund, which investors rely on when making the decision to invest.<sup>188</sup> Finally, under the third factor of the *Howey* test, an investor's profit expectations come from the promoter's efforts in actively trading and managing the fund.<sup>189</sup> For ex-

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183. *Id.* at 299–301; *Shavers*, 2013 WL 4028182, at \*2 ("It is clear that Bitcoin can be used as money. It can be used to purchase goods or services, and as *Shavers* stated, used to pay for individual living expenses. . . . [I]t can also be exchanged for conventional currencies, such as the U.S. dollar, Euro, Yen, and Yuan").

184. See, e.g., Steve Forbes, Opinion, *Bitcoin: Whatever It Is, It's Not Money!*, FORBES (Apr. 4, 2013, 10:50 AM), <http://www.forbes.com/sites/steveforbes/2013/04/16/bitcoin-whatever-it-is-its-not-money/>. Forbes argues that "[y]ou can't have a functional money without a basic transparency," which is inapplicable to Bitcoin since it is neither a hard asset nor does the U.S. government back it. *Id.*

185. Paul Vigna, *BitBeat: Apple Drops Bitcoin App from App Store, Bitcoiners Not Happy*, WALL ST. J. MONEYBEAT (Feb. 6, 2014, 5:54 PM), [http://blogs.wsj.com/moneybeat/2014/02/06/bitbeat-apple-drops-bitcoin-app-from-app-store-bitcoiners-not-happy/?mod=wsj\\_valettop\\_email](http://blogs.wsj.com/moneybeat/2014/02/06/bitbeat-apple-drops-bitcoin-app-from-app-store-bitcoiners-not-happy/?mod=wsj_valettop_email). Global fund manager Payden & Rygel argues that "[m]oney need not be paper in the pocket. Money needs neither government nor regulatory approval. Money is more an adjective than a noun, a way to make trade easier and holds no intrinsic value." *Id.* Furthermore, the district judge in *Ulbricht* stated that "Bitcoins carry value—that is their purpose and function—and act as a medium of exchange," arguably suggesting it is classified as money. *United States v. Ulbricht*, No. 14-cr-68, at 5 (S.D.N.Y. Jul. 9, 2014) (opinion and order denying defendant's motion to dismiss).

186. *Shavers*, 2013 WL 4028182, at \*2 (memorandum opinion regarding the court's subject matter jurisdiction); see also BLACK'S LAW DICTIONARY 1096 (9th ed. 2009) (defining e-money as a "[m]oney or a money substitute that is transformed into information stored on a computer or computer chip so that it can be transferred over information systems such as the Internet"). This broad definition of e-money does not require government or tangible asset backing.

187. *Shavers*, 2013 WL 4028182, at \*2 (relying on the Fifth Circuit interdependence test to find that the investors relied on Shaver's "expertise in the Bitcoin markets and his local connections").

188. *Id.*

189. *Id.* at \*1–2. "Clearly any investors participating in the BTCST investments were expecting profits from the efforts of *Shavers*' because he promised a 1% daily return." *Id.* at \*2.



ample, an investor who invests money into the Winklevoss Bitcoin Trust does not actively manage the fund, but instead relies solely on the promoter to manage the fund, and earns a profit based on the promoter's knowledge of Bitcoin trading.<sup>190</sup>

Because investments in Bitcoin financial products should be considered "investment contracts," persons offering these investment opportunities may be required to file a registration statement with the SEC to be made public prior to offering the security on the market.<sup>191</sup> Pursuant to the Securities Act, this registration must comply with the requirements of Schedule A by including a description and quantity of the assets underlying the security, a description of the purpose of the security, a balance sheet, and a profit/loss statement.<sup>192</sup> These disclosure requirements ensure that investors know the risks associated with investing in the security and the asset behind it, which is consistent with the SEC's purpose of protecting investors from unnecessary risks that result from a lack of information.<sup>193</sup>

It is clear that investments in Bitcoin financial products should be considered investment contracts and therefore securities, but the same cannot be said for Bitcoin Exchanges or Bitcoins themselves. Unlike investments in financial products, it seems that Bitcoin Exchanges cannot be considered common enterprises because a person trading Bitcoins on an exchange is likely relying on her own knowledge of the currency when making the trades and not on investment or trading advice provided by the exchange. Bitcoin Exchanges, therefore, fall outside the realm of the securities laws.<sup>194</sup> Furthermore, Bitcoin itself is not a common enterprise under the *Howey* test because investors are not relying on a promoter to earn a profit; instead, the investor is solely responsible for managing her own Bitcoin, similar to the exchanges.<sup>195</sup> Unlike financial products, Bitcoin Exchanges and Bitcoin itself do not pose the same risks associated with third-party involve-

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190. Winklevoss Bitcoin Trust, *supra* note 1, at 38–41. Note the similarities between the Winklevoss Bitcoin Trust and the BTCST investment in *Shavers*. Compare *id.* with *Shavers*, 2013 WL 4028182, at \* 1.

191. See 15 U.S.C. § 77(f) (2012). For an example of a Bitcoin security registration filed with the SEC, see Winklevoss Bitcoin Trust, *supra* note 1.

192. 15 U.S.C. § 77aa, Schedule A. Note that the registration statement must also contain a statement of legality and statement from the counsel in connection with the security registration. *Id.* For a discussion of possible exemptions for smaller offerings, see 17 C.F.R. § 230.500 (2013) (noting that "Regulation D relates to transactions exempted from the registration requirements of section 5 of the Securities Act of 1933").

193. Dion, *supra* note 62, at 192–93 (citing DONNA M. NAGY ET AL., SECURITIES LITIGATION & ENFORCEMENT 2 (3d ed. 2012)).

194. Grinberg, *supra* note 156, at 194–200.

195. See *id.* at 197–98.

ment and manipulation of the product, and therefore do not require the protection offered from disclosure requirements.<sup>196</sup>

Evan Greebel, an attorney for the Winklevoss Bitcoin Trust, stated that “[t]he SEC has generally been receptive” to working through the registration process because “the SEC understands the nature of the project and understands that it does bring stability to [B]itcoin.”<sup>197</sup> According to Mr. Greebel, the Exchange-Traded Fund will increase speculative investment opportunities for institutional investors, reducing Bitcoin’s price volatility.<sup>198</sup> Without regulation, banks and investors will be reluctant to purchase shares in a Bitcoin financial product due to its uncertainty. This reluctance could ultimately reduce investment in the U.S. and possibly increase investment in other countries because Bitcoin “will surely move forward with or without American investment.”<sup>199</sup> Without U.S. regulation of Bitcoin financial products, individuals will instead invest in foreign Bitcoin markets,<sup>200</sup> perhaps causing Bitcoin to be primarily used to facilitate criminal activity in the United States.

### 3. Internal Revenue Service

Prior to March 2014, taxpayers faced great uncertainty regarding the characterization and recognition of income or gain from Bitcoin transactions.<sup>201</sup> To address this uncertainty, the IRS issued Notice 2014-21, which defined Bitcoin as property for tax purposes.<sup>202</sup> The IRS was ill-advised in classifying Bitcoin as property, as this definition reflects an inaccurate view of virtual currencies. Instead, the IRS should have classified Bitcoin as currency because Bitcoin is similar in substance to foreign currency.

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196. Gavyn Davies, *Bitcoin: Miracle or Madness?*, FIN. TIMES (Jan. 19, 2014, 2:46 PM), <http://blogs.ft.com/gavyndavies/2014/01/19/Bitcoin-miracle-or-madness/>.

197. Michael J. Casey, *Lawyer for Winklevoss Twins’ Bitcoin ETF Says SEC Review Going Smoothly*, WALL ST. J. MONEYBEAT (Jan. 17, 2014, 4:10 PM), <http://blogs.wsj.com/moneybeat/2014/01/17/lawyer-for-winklevoss-twins-bitcoin-etf-says-sec-review-going-smoothly/>.

198. *Id.*

199. Brian Patrick Eha, *Why Regulate Bitcoin?*, NEW YORKER (Nov. 18, 2013), <http://www.newyorker.com/online/blogs/currency/2013/11/why-regulate-bitcoin.html>; see also Casey, *supra* note 197.

200. See *infra* notes 279–281 and accompanying text.

201. See Lowy & Abraham, *supra* note 154, at 649–55; see also Laura Saunders, *Another Bitcoin Mystery: How Will the IRS Tax It?*, WALL ST. J. (Dec. 20, 2013, 11:05 PM), <http://online.wsj.com/news/articles/SB10001424052702304773104579268322915488180>.

202. I.R.S. Notice 2014-21, *supra* note 10, at 938 (noting that “[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency”).

a. IRS Treatment of Initial Receipt of Bitcoin

A person may initially receive Bitcoin in three ways: (1) as compensation for services; (2) as payment for goods; or (3) by purchase.<sup>203</sup> Each of these transactions has tax consequences. For tax purposes, the IRS will treat a taxpayer who receives Bitcoin as though she had received other property.<sup>204</sup> For instance, if the taxpayer performs services valued at \$1,000 in exchange for \$1,000 worth of Bitcoin, she recognizes \$1,000 of income from providing services.<sup>205</sup> She should to take a \$1,000 basis in Bitcoin because giving her a \$1,000 basis ensures she does not recognize a further gain or loss if she exchanges her Bitcoins for \$1,000 cash.<sup>206</sup> The same result follows if the taxpayer mines \$1,000 worth of Bitcoin.<sup>207</sup>

Similarly, if the taxpayer sells a t-shirt online for Bitcoin worth \$20, she recognizes a gain from selling this t-shirt.<sup>208</sup> This gain is identical to the amount and character of gain she realizes if she had instead sold the t-shirt for \$20 cash.<sup>209</sup> The taxpayer's basis in Bitcoin received is \$20, ensuring that she does not recognize any additional gain or loss if she exchanges the Bitcoin for \$20 cash.<sup>210</sup> If instead the taxpayer pays \$500 cash to acquire \$500 worth of Bitcoin on an exchange, she should not recognize a gain or loss at the time of acquisition. She takes a basis of \$500 in the Bitcoin acquired for that reason.<sup>211</sup>

b. Holding and Later Exchanging Bitcoin: Recognizing Gains and Losses

The IRS has also clarified the tax consequences of holding and later exchanging Bitcoin for cash, property, or services. Pursuant to Notice 2014-21, Bitcoin is classified as property where "[t]he character of the

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203. See generally GAO-13-1516, *supra* note 81.

204. *Id.*

205. I.R.C. § 61 (2012); see also 26 C.F.R. § 1.61-1 (2012).

206. I.R.C. § 1012 ("The basis of property shall be the cost of such property . . ."); see also Lowy & Abraham, *supra* note 154, at 654; I.R.S. Notice 2014-21, *supra* note 10, at 938-39 (describing the fair market value of Bitcoin).

207. I.R.C. § 61; see also 26 C.F.R. § 1.61-1. Mining is considered a taxable event because the miner earns Bitcoin as income for the service of solving the complex mathematical equation. I.R.S. Notice 2014-21, *supra* note 10, at 939 (describing the taxation of mining). See generally Lowy & Abraham, *supra* note 154, at 653.

208. I.R.C. § 1; see also I.R.S. Notice 2014-21, *supra* note 10.

209. See *supra* note 208.

210. I.R.C. § 1012. See generally Lowy & Abraham, *supra* note 154, at 654.

211. I.R.C. § 1012.

gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer.”<sup>212</sup>

When Bitcoin is treated like a capital asset, gain or loss recognition would be considered capital gain or loss.<sup>213</sup> Assume a taxpayer holds a Bitcoin asset with a basis of \$1,000 and exchanges the Bitcoin for one of the following: (1) \$1,500 cash; (2) \$1,500 worth of property; or (3) \$1,500 worth of services. As a result of these transactions, the taxpayer recognizes \$500 in capital gain.<sup>214</sup> If the taxpayer holds the Bitcoin for longer than one year before the exchange, the resulting gain is characterized as long-term capital gain.<sup>215</sup> If the taxpayer holds the Bitcoin for less than a year before the exchange, the resulting capital gain is short-term capital gain.<sup>216</sup> Assuming the taxpayer has not recognized other capital gains or losses, the short-term gain is taxed at the same rate as ordinary income, while the long-term gain is taxed at more favorable rates.<sup>217</sup>

Classifying Bitcoin as a capital asset is a logical approach in some circumstances. In its filing with the SEC, the Winklevoss Bitcoin Trust purports to treat Bitcoins as a capital asset under Section 1221 of the Code.<sup>218</sup> Bitcoin could be considered “investment property” when it is purchased as an investment because people purchasing shares in the Bitcoin Trust are investing presumably to speculate as to the currency’s future value.<sup>219</sup> However, imagine that the Winklevoss twins form a “Winklevoss Euro Trust”—an entity treated like a partnership for tax purposes that caters to U.S. investors and acquires Euros as investments—hoping to earn a profit when the Euro increases in value against the U.S. dollar.<sup>220</sup> In this hypothetical, gain recognized by U.S. investors is treated as foreign currency gain rather than gain from

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212. I.R.S. Notice; 2014-21, *supra* note 10, at 939. Examples of capital assets are stocks, bonds, and other investment property, whereas examples of instances when a non-capital asset gives rise to ordinary income includes inventory and property held by a trade or business. *Id.*

213. I.R.C. § 1(h).

214. I.R.C. § 1222 (calculating capital gain or loss by subtracting the basis from the value of Bitcoin at the time of the transaction).

215. *Id.*

216. *Id.*

217. I.R.C. § 1(h) (2013 & Supp. 2014). For example, the maximum rate for short-term gains is 39.6% as opposed to 20% max on long-term gains. *Id.*

218. Winklevoss Bitcoin Trust, *supra* note 1, at 72–74. Section 1221 specifically excludes derivative instruments from the definition of capital assets. I.R.C. § 1221 (2012). A complete analysis of the taxation on Bitcoin derivatives is beyond the scope of this Comment.

219. 26 C.F.R. § 1.988-1 (2013).

220. For a Euro Trust identical to this hypothetical, see Prospectus for FXE Currency Shares Euro, Guggenheim Investments, at 1–2, 36–37 (Feb. 18, 2013) [hereinafter FXE Currency Shares Euro].

the sale of a capital asset, notwithstanding the Winklevoss Euro Trust's investment purpose.<sup>221</sup>

Accordingly, classifying Bitcoin as foreign currency is a more logical and preferred approach<sup>222</sup> because it adheres to the substance over form doctrine. As is the case with other foreign currencies, Bitcoin circulates as a medium of exchange, defined as "a measure and standard of value in commercial transactions between buyers and sellers," because people accept Bitcoins as payment for goods and services.<sup>223</sup> It can also be readily exchanged for other national currencies on Bitcoin Exchanges at the going market rate, including the U.S. dollar, Euro, Yen and Yuan.<sup>224</sup>

When Bitcoin is properly classified as foreign currency, a holder of Bitcoin recognizes ordinary income or loss upon the exchange of Bitcoin for cash, other property, or services.<sup>225</sup> Assume the taxpayer holds Bitcoin with a basis of \$1,000.<sup>226</sup> If the taxpayer sells the Bitcoin for \$1,500 cash, she recognizes \$500 of ordinary income at the time of sale.<sup>227</sup> Ordinary income is taxed at graduated rates up to a maximum of 39.6% under current U.S. law.<sup>228</sup> If the taxpayer uses the \$1,000 of Bitcoin to acquire property or services worth \$1,500 instead of selling the Bitcoin for cash, she recognizes \$500 of ordinary income.<sup>229</sup>

The IRS was correct not to classify Bitcoin as a good or commodity because Bitcoin is not "[t]angible or movable personal property other than money" and is instead more similar in substance to money because it acts as a store of value.<sup>230</sup> Bitcoins are moveable in that they

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221. See I.R.C. § 988; see also *FXE Currency Shares Euro*, *supra* note 220, at 37.

222. See Letter from Carol G. Warley, Chair, Federal Tax Policy Committee, Texas Society of Certified Public Accountants, to John A. Koskinen, Commissioner, Internal Revenue Service (Sept. 22, 2014) (on file with author) (noting that "[b]ecause a virtual currency functions as a currency, is widely accepted in some cases as tender and is a fungible asset, drawing on the large body of case law, regulations and rulings that already exists with respect to foreign currency transactions would present a more sensible approach").

223. Lowy & Abraham, *supra* note 154, at 652; see also *SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182, at \*2 (E.D. Tex. filed Aug. 6, 2013) (memorandum opinion regarding the court's subject matter jurisdiction). For a definition of money, see BLACK'S LAW DICTIONARY 1096 (9th ed. 2009). For a definition of currency, see *id.* at 440. For a definition of medium exchange, see *id.* at 1072.

224. *Shavers*, 2013 WL 4028182, at \*2.

225. I.R.C. §§ 61, 64.

226. See *supra* notes 205–211 and accompanying text.

227. I.R.C. § 64 ("[T]he term 'ordinary income' includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).").

228. I.R.C. § 1.

229. I.R.C. § 64.

230. BLACK'S LAW DICTIONARY 762 (9th ed. 2009) (defining "goods"). For a definition of money, see *id.* at 1096. See also Paul H. Farmer Jr., Note & Comment, *Speculative Tech: The Bitcoin Legal Quagmire & the Need for Legal Innovation*, 9 J. BUS. & TECH. L. 85, 93 (2014)

are transferred from one user to another, but are not tangible because they exist solely online.<sup>231</sup> Instead, Bitcoin should be classified under a broad definition of money that includes e-money, because it is an asset that can be easily converted into USD on Bitcoin Exchanges, and acts as money transferred over the Internet and stored as a mathematical equation within the Bitcoin blockchain.<sup>232</sup> Furthermore, Bitcoin should not be classified as a good, nor should transactions in Bitcoin be treated as barter transactions. A barter transaction occurs when goods or services are exchanged for other goods or services directly, without the exchange of cash.<sup>233</sup>

Because Bitcoin can be a capital asset in some instances, investors can be subject to more favorable tax rates than if treated as currency.<sup>234</sup> Presumably, this classification was selected “since virtual currencies are still in an infancy stage and there are limited markets that will accept virtual currency in lieu of conventional currency . . . .”<sup>235</sup> This classification also encourages investment into an investment trust like the one set up by the Winklevoss brothers because of the favorable capital gain treatment as compared with traditional currency trusts.<sup>236</sup> Despite this favorable tax treatment, Bitcoin is properly classified as currency because Bitcoin is similar in substance to foreign currency.<sup>237</sup> The number of retailers that accept payment in Bitcoin demonstrates the growing acceptance of Bitcoin as a medium of exchange and a store of value.<sup>238</sup> For businesses that accept Bitcoin as part of their ordinary course of business, treating Bitcoin as prop-

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(“As a concept, money is traditionally defined as a medium of exchange, a unit of account, and a store of value.”).

231. See Winklevoss Bitcoin Trust, *supra* note 1, at 26–28.

232. See *id.*; see also *supra* note 230 and accompanying text.

233. See generally Robert I. Keller, *The Taxation of Barter Transactions*, 67 MINN. L. REV. 441 (1982). A complete analysis of Bitcoin transactions as barter transactions is beyond the scope of this Comment.

234. See Winklevoss Bitcoin Trust, *supra* note 1, at 72; see also I.R.C. § 64.

235. Lowy & Abraham, *supra* note 154, at 653.

236. For a comparison of the tax treatment of the Winklevoss Bitcoin Trust with the FXE Currency Shares Euro, see *supra* notes 218–221 and accompanying text.

237. For an international perspective on classifying Bitcoin for tax purposes, see Neelabh Chaturvedi, *U.K. Nears Rules on Taxing Bitcoin*, WALL ST. J. (Mar. 2, 2014, 3:17 PM), [http://online.wsj.com/news/article\\_email/SB10001424052702304360704579415352635879152-1MyQjAxMTA0MDAwMzEwNDMyWj](http://online.wsj.com/news/article_email/SB10001424052702304360704579415352635879152-1MyQjAxMTA0MDAwMzEwNDMyWj) (noting that “[t]he U.K.’s tax authority is near to issuing rules that would treat virtual currencies much like regular money”).

238. Lowy & Abraham, *supra* note 154, at 653 (noting that “as virtual currency gains popularity and becomes more accepted, creating a larger virtual economy that can be used to purchase real-world goods and services, the view of virtual currency as an actual currency would become stronger”).

erty imposes unmanageable and impractical requirements.<sup>239</sup> Additionally, FinCEN has already characterized Bitcoin as “virtual currency” under its laws.<sup>240</sup> For administrative efficiency and to ensure that Bitcoin is treated uniformly under the law, the IRS should classify Bitcoin as currency.

### c. IRS Reporting Requirements

Finally, the IRS has issued guidance regarding reporting requirements associated with Bitcoin transactions. One way the IRS ensures compliance through the Code is by establishing reporting requirements for certain transactions.<sup>241</sup> Currently, Bitcoin is “subject to information reporting to the same extent as any other payment made in property.”<sup>242</sup> Even though there are very few employers who pay an employee’s salary in Bitcoin, those that do should complete Form W-2.<sup>243</sup> Aside from Form W-2 for salary reporting, Bitcoin transactions are subject to Form 1099 reporting depending on the nature of the transaction. Bitcoin Exchanges such as Bitstamp are required to complete Form 1099-B because these exchanges are “dealers” within the meaning of the Code.<sup>244</sup> Requiring exchanges to supply this form will further reduce the anonymity issues that lead to tax evasion. However, for the current tax year, the IRS has stated that taxpayers do not have to report virtual currencies like Bitcoin on a Report of Foreign Bank and Financial Accounts (FBAR) that is filed with the U.S. Treas-

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239. Letter from Carol G. Wharley, *supra* note 222, at 3 (stating that “[i]mposing treatment as property upon a merchant would result in the merchant having to track each individual transaction, apply an uncertain valuation process, and report each transaction separately as a capital gain or loss”).

240. FIN-2013-G001, *supra* note 9, at 1.

241. GAO-13-516, *supra* note 81, at 9. Note that both FinCEN and the IRS have similar reporting requirements. For a more detailed account of all the differing reporting requirements, see also 1 FEDERAL TAX PRACTICE AND PROCEDURE § 5.03 (2013).

242. I.R.S. Notice 2014-21, *supra* note 10, at 939.

243. I.R.C. § 6051 (2012); 26 C.F.R. §§ 31.6051-1, 31.6051-2 (2013); see also Lowy & Abraham, *supra* note 154, at 654. A police chief in Kentucky is being paid his salary in Bitcoin. Chris Richtie, *Chief Asks To Be Paid in Bitcoin, City Approves*, POLICEONE (Dec. 4, 2013), <http://www.policeone.com/police-administration/articles/6643566-Chief-asks-to-be-paid-in-Bitcoin-city-approves/>.

244. I.R.C. § 6045; see also *Instructions for Form 1099-B*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/pub/irs-pdf/i1099b.pdf> (defining a broker as “any person who, in the ordinary course of a trade or business, stands ready to effect sales to be made by others”); Dion, *supra* note 62, at 198 (arguing that Bitcoin Exchanges should be subject to “rigorous accounting standards” and “should face rigorous audits by the IRS and be compelled to supply their traders with information to file a Form 1099(b)”).

surey,<sup>245</sup> which is required for individuals with a financial account in a foreign country.<sup>246</sup>

Even with clear guidance that the Code applies to a variety of Bitcoin transactions, tax evasion may continue to present an issue because, in many cases, the IRS will still depend on self-reporting by taxpayers. Bitcoin's anonymous nature exacerbates the problem because the IRS is unlikely to easily compel payment.<sup>247</sup> Despite this, Mt. Gox's decision to self-report in order to comply with FinCEN requirements demonstrates that Bitcoin Exchanges are willing to comply with regulatory laws, but have not done so due to confusion about proper compliance procedures. Consequently, some tax evasion will decrease as more people understand how to treat Bitcoin for tax purposes.<sup>248</sup> This supports the view that it is more intuitive to treat Bitcoin as currency.

#### 4. *Commodity Future Trading Commission*

Even though Bitcoin is physically intangible, it could be classified as a commodity for purposes of the Commodity Exchange Act.<sup>249</sup> Viewed broadly, Bitcoin can be a commodity because it is "an article of trade or commerce"<sup>250</sup> that is capable of constructive possession, making Bitcoin tangible.<sup>251</sup> Courts have held that currency can be constructively possessed, and Bitcoin is essentially a currency in that it

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245. Kelly Phillips Erb, *IRS Says Bitcoin Not Reportable on FBAR (For Now)*, FORBES (June 30, 2014, 11:06 AM), <http://www.forbes.com/sites/kellyphillipserb/2014/06/30/irs-says-bitcoin-not-reportable-on-fbar-for-now/> (a Forbes Contributor blog).

246. For more detail on FBARs, see Gruber, *supra* note 28, at 194–98.

[FBARs] must be filed by any "United States person having a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country." If the foreign financial account at any point exceeded \$10,000 in value during the previous year, an FBAR must be filed with the Commissioner of Internal Revenue on or before June 30 of that year.

*Id.* at 197 (quoting 31 C.F.R. § 1010.350 (2013)).

247. Dion, *supra* note 62, at 186–87; *see also* Marian, *supra* note 81, at 45–46 (noting that reporting requirements and other traditional "anti tax-evasion mechanisms" are not a sufficient solution to curb tax evasion). For a possible solution involving the Foreign Account Tax Compliance Act, see Gruber, *supra* note 28, at 203–04 and Marian, *supra* note 81, at 46.

248. GAO-13-516, *supra* note 81, at 1.

249. 7 U.S.C. § 1.

250. BLACK'S LAW DICTIONARY 310 (9th ed. 2009). For an analysis of foreign currency treatment under the CEA, see Elizabeth D. Lauzon, Annotation, *What Are "Contracts of Sale of a Commodity for Future Delivery" Within Meaning of Commodity Exchange Act*, 182 A.L.R. FED. 577–78 (2002).

251. Tom Johnson, *What U.S. Regulations Apply to Bitcoins as Commodities?*, BITCOIN TITAN & TRADING TITAN (2012), <http://blog.bitcointitan.com/post/17789738826/what-u-s-regulations-apply-to-bitcoins-as-commodities#>. "Constructive possession is '[c]ontrol or dominion over a property without actual possession or custody of it,' compared to actual possession, which is



can purchase goods and services based on an exchange rate, like currency.<sup>252</sup> However, this attenuated argument likely fails because Bitcoins are not physically tangible, which is the distinguishing characteristic of commodities as compared to other assets. Accordingly, it is unlikely that Bitcoin trades could be regulated as commodity futures.<sup>253</sup> However, the CFTC's Global Markets Advisory Committee held a meeting on October 9, 2014 to discuss "derivatives contracts that reference the digital currency [B]itcoin."<sup>254</sup>

Experts have argued that derivatives can stabilize volatile markets.<sup>255</sup> A regulated Bitcoin derivative like the TeraExchange SEF where investors can make swap trades "allows clients to protect the value of their [B]itcoin holdings by locking in a dollar value, offering an insurance against . . . astronomical price swings."<sup>256</sup> By minimizing the price volatility, these swaps legitimize Bitcoin as a payment method and will encourage more merchants to begin accepting payment in Bitcoin.<sup>257</sup> It appears that the regulatory approval of the first Bitcoin derivative is a step towards legitimizing Bitcoin as a mainstream virtual currency and investment vehicle that appeals to more than just risk-seeking venture capitalists.

#### IV. IMPACT

Regulations and guidelines for Bitcoin treatment under current financial and tax laws are necessary to provide stability for Bitcoin as an alternative currency and to legitimize it as a payment mechanism and investment vehicle. Currently, Bitcoin is virtually anonymous and

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'[p]hysical occupancy or control over property.'" *Id.* (quoting BLACK'S LAW DICTIONARY 1282 (9th ed. 2009)).

252. *Id.* ("Bitcoins are clearly useful articles of commerce capable of being possessed. Bitcoins are traded online every day for goods, services, U.S. dollars, and other currency.").

253. Groshoff, *supra* note 138, at 526–27.

254. Press Release, U.S. Commodity Futures Trading Comm'n, PR7010-14, CFTC's Global Markets Advisory Committee to Meet October 9, 2014 (Sept. 25, 2014), *available at* <http://www.cftc.gov/PressRoom/PressReleases/pr7010-14>.

255. Farivar, *supra* note 141 ("In general, derivative markets tend to make prices more stable rather than less," Eli Dourado, a research fellow at the Mercatus Center at George Mason University, who studies Bitcoin, told [the internet news site]. . . . "An ability to bet that it is a bubble can help to tame the bubble," he added."'). For a more detailed discussion of how derivatives can stabilize an asset's price, see generally Michael Bathon & Carla Main, *Bitcoin Meeting, OTC Derivatives, Trump U: Compliance*, BLOOMBERG (Aug. 27, 2013, 7:31 AM), <http://www.bloomberg.com/news/2013-08-27/bitcoin-meeting-otc-derivatives-trump-u-compliance.html>.

256. Douwe Miedema, *There's Now a Bitcoin Derivative You Can Trade*, BUS. INSIDER (Sept. 12, 2014, 8:49 AM), <http://www.businessinsider.com/r-bitcoin-gets-boost-as-us-watchdog-ap-proves-first-swap-2014-9>.

257. *Id.* (TeraExchange's Christian Martin states, "For a merchant to take [B]itcoin, there wasn't until this product a regulated way for them to put on a hedge to manage the risk . . . and now with this product they can." (second alteration in original)).

only regulated under the money laundering laws and the BSA, which apply only to financial institutions and Bitcoin Exchanges.<sup>258</sup> Bitcoin is currently treated as property under the Tax Code, and various transactions are subject to the same taxation and reporting requirements as other forms of property.<sup>259</sup> Additionally, investors can trade Bitcoin swaps on the TeraExchange, the first Bitcoin derivative trading platform approved and regulated by the CFTC.<sup>260</sup> The SEC has yet to issue clear guidelines as to how Bitcoins should be treated under its respective laws.<sup>261</sup> This Comment has argued that the SEC should regulate investments in Bitcoin financial products and that CFTC regulation of derivatives will likely stabilize Bitcoin's volatile price. Neither Bitcoin itself, nor the Exchanges, should be regulated. Regarding taxation, the IRS was ill-advised in classifying Bitcoin as property because Bitcoin should be treated as currency in all circumstances. Bitcoin is similar in substance to foreign currencies and should have been classified by the IRS accordingly.

Because there is no "central issuer or network operation" to authorize Bitcoin, regulation does not fit neatly under one governmental agency's jurisdiction.<sup>262</sup> Instead, multiple agencies must regulate different aspects of Bitcoin to form one complete regulatory framework. These governmental agencies must agree on a uniform classification for Bitcoin as currency; FinCEN first made such a classification, and it should be adopted by all other regulatory bodies for administrative efficiency.

Critics have argued that overregulation will drive Bitcoin consumers outside the United States.<sup>263</sup> These individuals believe that Bitcoin should remain part of an unregulated free market in which supply and demand attach a value to Bitcoin and any price fluctuation should work themselves out and stabilize through market forces. The argument for no regulation ignores the reality that Bitcoin's price is too volatile in the free market to compete with other stable national currencies. If the goal for Bitcoin was to create a localized and specific hobby market that does not aim to trade and compete with other national currencies in the foreign exchange markets, no regulation would be necessary. But supporters argue that the central goal of Bitcoin is its use as a mainstream virtual currency, requiring regulation to

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258. See *supra* notes 110–112 and accompanying text.

259. See *supra* notes 201–248 and accompanying text.

260. See *supra* note 11 and accompanying text.

261. See *SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182, at \*2 (E.D. Tex. filed Aug. 6, 2013) (memorandum opinion regarding the court's subject matter jurisdiction).

262. Borak, *supra* note 21.

263. Gruber, *supra* note 28, at 189; see also Eha, *supra* note 199.

stabilize its price. Furthermore, banks such as Wells Fargo are exploring the possibility of “offering services to virtual currency startups.”<sup>264</sup> Without regulation to curb illegal activity, individuals and businesses will be hesitant to invest in Bitcoin because the risk is too great.

Other critics have suggested that banning Bitcoin, as opposed to not regulating it, is a more feasible alternative.<sup>265</sup> These individuals argue that the U.S. should join China and Russia by banning the currency, allowing only private individuals to trade on exchanges and forbidding financial companies from investing in Bitcoin.<sup>266</sup> Concerns over money laundering and other illegal activity fuel this position.<sup>267</sup> However, banning Bitcoin in the U.S. is counterintuitive because it will likely increase criminal activity while making it more difficult for the government to detect.<sup>268</sup> Just as the alcohol prohibition during the 1920s failed to reduce demand for alcohol, a ban on Bitcoin is unlikely to reduce the demand for Bitcoin.<sup>269</sup> People will still engage in Bitcoin transactions because a government ban would not affect Bitcoin creation. Additionally, a ban on Bitcoin would further increase criminal activity and Bitcoin’s prevalence in the “underground” markets.<sup>270</sup> The moderate regulation for which this Comment advocates, therefore, is more beneficial than either extreme if the goal is to curb criminal activity and promote the use of Bitcoin as a payment mechanism and investment vehicle.

Given the efficiency and ease of payment transfers, Bitcoin has the potential to surpass other payment system competitors.<sup>271</sup> FinCEN’s

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264. Stephen Foley & Camilla Hall, *Wells Fargo Calls Bitcoin Summit on “Rules of Engagement,”* FIN. TIMES (Jan. 14, 2014, 6:30 PM), <http://www.ft.com/intl/cms/s/0/cf57a59c-7d39-11e3-a579-00144feabdc0.html#axzz2semSjpnx>. The real threat to Bitcoin’s future is not overregulation, but rather continued regulatory uncertainty despite consumer and financial institution demand and willingness to take part in Bitcoin.

265. Hiroko Tabuchi & Rachel Abrams, *Now, Nations Mull the Ways to Regulate Bitcoin*, N.Y. TIMES, Feb. 27, 2014, at B4. This view was especially prevalent at the time of the Mt. Gox theft and bankruptcy proceeding. *Id.*

266. Andy Greenberg, *Senator Calls for Bitcoin Ban in Letter to Financial Regulators*, FORBES, (Feb. 26, 2014, 3:17 PM) <http://www.forbes.com/sites/andygreenberg/2014/02/26/senator-calls-for-bitcoin-ban-in-letter-to-financial-regulators/> (a Forbes Contributor blog).

267. *After China, Russia Bans Bitcoin over Money Laundering Concerns*, BUS. STANDARD (Feb. 8, 2014, 12:25 PM), [http://www.business-standard.com/article/international/after-china-russia-bans-bitcoin-over-money-laundering-concerns-114020800332\\_1.html](http://www.business-standard.com/article/international/after-china-russia-bans-bitcoin-over-money-laundering-concerns-114020800332_1.html).

268. Jon Matonis, *Government Ban on Bitcoin Would Fail Miserably*, FORBES (Jan. 28, 2013, 9:39 AM), <http://www.forbes.com/sites/jonmatonis/2013/01/28/government-ban-on-bitcoin-would-fail-miserably/> (a Forbes Contributor blog).

269. *Id.*

270. *Id.*

271. John Gapper, *Bitcoin Is Far More than a Currency for Speculators*, FIN. TIMES, Feb. 5, 2014, at 7, available at <http://www.ft.com/intl/cms/0/612ed094-8aaf-11-e3-9465-00144feab7de>

extension of its regulations to Bitcoin was necessary to achieve this end because people would not trust Bitcoin without the money laundering guidelines, preventing Bitcoin from becoming widely accepted.<sup>272</sup> This distrust exists because Bitcoin has no inherent value, causing investors to be naturally skeptical about the legitimacy of Bitcoin transactions.<sup>273</sup> However, one exchange's willing compliance with money laundering laws<sup>274</sup> demonstrates that entrepreneurs also believe regulation is necessary to increase Bitcoin's status as an alternative payment system.<sup>275</sup>

Regulating Bitcoin investments under U.S. securities law would provide increased consumer and investor protection, which would increase the prevalence of Bitcoin financial products. Investor risk, both to small and large institutional investors, threatens Bitcoin's future because of concern about a speculative price bubble.<sup>276</sup> This concern is made worse by Bitcoin's lack of government backing or inherent value.<sup>277</sup> Regulating Bitcoin investments would serve as a stamp of approval from the government, indicating that Bitcoin is the equivalent of money and, given proper disclosures, that the possible rewards of investment outweigh the risks. Former Federal Reserve Chairman Ben Bernanke agrees that Bitcoin has "long-term promise," and support from the Federal Reserve can alleviate investor concern regarding a price bubble and future price stability.<sup>278</sup>

The U.S. currently accounts for 82% of the trading on Bitcoin Exchanges.<sup>279</sup> The ban of Bitcoin by other countries presents increased opportunities for the U.S. to increase its market share of Bitcoin transactions. This increase in Bitcoin transactions will provide additional capital and tax revenue generated by Bitcoin investments. Further, there is a first-mover advantage to the U.S. by being one of the

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.html. The Federal Trade Commission is considering regulating Bitcoin to ensure consumer protection. Ryan Tracy & Stephanie Armour, *Losses Mobilize the Bitcoin Police*, WALL ST. J., March 3, 2014, at C1 (noting that "the FTC's goal 'is to protect consumers, whether they pay by credit card, check, by some sort of virtual currency'").

272. Gruber, *supra* note 28, at 176–78.

273. See Gapper, *supra* note 271 ("A virtual currency with no central bank backing and no yield is worse than a casino chip.").

274. Kastrenakes, *supra* note 175.

275. See Gapper, *supra* note 271\* ("Mr. Lawsy is right to create a legal order for virtual transactions, rather than trying to stamp on Bitcoin, as some governments are starting to do. It would be feasible to push Bitcoin and similar initiatives underground but it would also be a wasted opportunity.").

276. *Id.*

277. *Id.*

278. Davies, *supra* note 196.

279. *Exchange Volume Distribution*, *supra* note 32.

first countries to regulate and accept Bitcoin as a form of currency.<sup>280</sup> Once Bitcoin gains international acceptance, a robust regulatory scheme should already exist in the U.S., making it the most legitimate market worldwide. Additionally, future Bitcoin regulation may require international cooperation.<sup>281</sup> For now, the U.S. should be concerned with its own regulation of Bitcoin in order to set the regulatory stage and become one of the first countries to express approval for the virtual currency.

## V. CONCLUSION

The U.S. government has yet to comprehensively regulate Bitcoin, the popular virtual currency. Extending current financial and tax laws to Bitcoin will combat its anonymity, reducing criminal activity and price volatility in the market. Only then can Bitcoin become a viable alternative payment method and investment vehicle. FinCEN's guidance regarding Bitcoin was beneficial not only to bring the currency under the anti-money laundering laws, but also to provide a uniform classification of Bitcoin as currency. Following FinCEN, the IRS should have classified Bitcoin as currency under the Code to maintain regulatory uniformity and reflect a more accurate understanding of virtual currency. The SEC and CFTC should regulate certain investments in Bitcoin financial products and derivatives to provide necessary investor protection and price stability. Virtual currencies like Bitcoin are the future, which is why American regulators should begin debating the proper way to regulate them in order to ensure their future stability.

*Nicole Mirjanich\**

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280. The German government has recognized Bitcoin as a "unit of account," which is a financial instrument under German banking rules "akin to 'private money.'" Matt Clinch, *Bitcoin Recognized by Germany as "Private Money,"* CNBC (Aug. 19, 2013, 10:25 AM), <http://www.cnbc.com/id/100971898#>. "[I]t is interesting that Germany has gone ahead and given legal status to [Bitcoin], as it could become an alternative to the euro if the single currency ever ceased to exist." *Id.*

281. See Knight & Yamaguchi, *supra* note 55 (reporting a statement from Japanese vice finance minister that "[a]ny regulation of the bitcoin crypto-currency should involve international cooperation to avoid loopholes").

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